Supreme Court of the United States

OCTOBER TERM, 1965

No. 535

UNITED STATES, PETITIONER

vs.

JOHN CATTO, JR., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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[fol. A]

[File Endorsement Omitted]

[fol. 1]

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

Civil Action No. 3060

JOHN CATTO, JR. AND ROXANA CATTO, his wife,
PLAINTIFFS

vs.

UNITED STATES OF AMERICA, DEFENDANT

STIPULATION OF FACTS

The parties to the above-entitled case, through their respective attorneys, agree that the following facts may be taken as true for the purpose of this action without further proof or foundation:

1. Plaintiffs, John Catto, Jr. and Roxana Catto, are husband and wife and at all times material hereto were residents of Bexar County, City of San Antonio, State of Texas.

2. During the years 1954 and 1955, and for many years prior and subsequent thereto, Plaintiffs were engaged in the ranching business. In connection with their ranching business, Plaintiffs own and operate two ranches in West Texas. One ranch, which is located in Brewster County, is known as the Marathon Ranch and consists of approximately 173,000 acres. The other ranch which is located in Presidio County, is known as the Marfa ranch and consists of approximately 20,000 acres. For a number of years Plaintiffs leased without interruption approximately 15,000 additional acres adjoining the Marfa Ranch. These ranches were originally owned and operated as a sole proprietorship by Plaintiff-Roxana Catto's father and

[fol. 2] mother, Mr. and Mrs. A. S. Gage. In 1924 Mrs. Gage died and devised her community one-half interest in the community estate in trust for the benefit of her two daughters (Plaintiff-Roxana Catto and her sister) with her husband as trustee. Thereafter the ranches were operated as an informal partnership by Mr. Gage in his capacity as trustee for his two daughters under Mrs. Gage's will and in his individual capacity. In 1928 Mr. Gage died; under his will his interest in the ranches was devised in trusts for ten years for the benefit of his two daughters (Plaintiff-Roxana Catto and her sister); the trustees appointed in his will were Warren Henderson and A. J. Roberts. For ten years, from 1928 to 1938, the ranch operations were conducted as a partnership by trustees. In 1938 the trusts and partnership were terminated. In that year Plaintiffs John and Roxana Catto were married. From 1938 to 1949 the ranching operations were conducted as a partnership between the two daughters (and their respective husbands). In September 1942 the Marathon ranch lands were partitioned between the daughters, and in June 1944 the Marfa Ranch lands were partitioned between the daughters; however, the ranching operations were continued at both ranches as a partnership by the daughters (and their respective husbands). On December 31, 1948, the partnership ranching operations at the Marathon ranch were terminated and equally divided between the daughters. Thereafter, the two daughters each had a separate ranch at Marathon and each ranch was operated separately on an individual basis. On December 31, 1951, the partnership ranching operations at the Marfa ranch were terminated and equally [fol. 3] divided between the daughters, who thereafter operated their respective portions separately. Since the termination of the partnership operations at the Marathon on December 31, 1948, and at the Marfa ranch on December 31, 1951, respectively, the Cattos have conducted their ranching operations as a sole proprietorship and maintained separate books and records and filed their tax returns on such basis. No partnership tax returns were filed for years after 1951.

3. The ranching business conducted by Plaintiffs consisted of breeding and raising cattle for the production

and sale of calves. Customarily the animals sold by the Plaintiffs are sent to the Midwest by purchasers for fattening and ultimate sale for beef or slaughter purposes. In connection with the ranching business Plaintiffs maintained a breeding herd of Hereford cattle. As circumstances required Plaintiffs purchased bulls and cows for addition to their breeding herd, to increase the herd, improve the quality and prevent inbreeding. Also, as circumstances required, the Plaintiffs selected certain calves produced from the breeding herd and added the same to the breeding herd. The number of animals to be retained in the breeding herd was determined on the basis of range conditions, rainfall, costs of operation and other factors. When required by age, disease and other circumstances, the Plaintiffs culled from the breeding herd and sold animals which were unfit for breeding stock or which for some other reason could not be retained. Calves produced by the breeding herd and not added to the breeding herd were sold in the due course of business.

4. Prior to 1920 the Gage ranches kept their books on the cash basis. In approximately 1920, as a result of an [fol. 4] examination of their income tax returns by the Internal Revenue department, Mr. and Mrs. A. S. Gage adopted the accrual (inventory) basis and commenced valuing their inventory of livestock under a unit-livestock-price method. Such method was continued by the various partnerships which operated the ranches up to 1938. When the two daughters (Plaintiff, Roxana Catto, and her sister), with their respective husbands, commenced operating the ranches as a partnership in 1938 they continued to use this method; and when the partnership operations were terminated and Plaintiffs commenced operation of their Marathon and Marfa ranches as a sole proprietorship, they used this method.

5. During the years 1954 and 1955, Plaintiffs kept their books and records on the accrual (inventory) and calendar year basis, and used the unit-livestock-price method of valuing inventory. In accordance with applicable Treasury Regulations, Plaintiffs included all livestock raised and held for sale in inventory. In addition, in accordance with the applicable Treasury Regulations, Plain-

tiffs included raised animals constituting the breeding herd and held by them for breeding purposes in inventory.

6. Under the unit-livestock-price method, Plaintiffs assigned to the various kinds, classifications and categories of raised breeding herd animals included in inventory in unit value. As such raised animals advanced in age, Plaintiffs accrued with respect to such animals the appropriate unit values. The kinds, classifications, categories and unit values assigned to raised breeding herd animals during the years 1954 and 1955 and prior thereto were [fol. 5] as follows:[1]

NON-REGISTER [2]	
Heifer yearlings	$ 25.00
Cows, two-year-old	30.00
Cows, three-year-old	35.00
Bulls	100.00

REGISTERED	
Calves	$ 50.00
Heifer yearlings	75.00
Cows	100.00
Bulls	100.00

7. The inclusion of the raised animals in inventory resulted in increasing the Plaintiffs' ordinary income in an amount equal to the value of the new animals included in inventory for the first time plus an amount equal to the annual increase in value for those animals already in inventory (because the increase in closing inventory de-

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[1] The partnership between the two daughters (Plaintiff, Roxana Catto, and her sister) and their respective husbands began using these particular unit values on January 1, 1942, and continued to use them throughout the duration of the partnership. When Plaintiffs commenced operating the ranches as a sole proprietorship they used the same unit values.

[2] Other values for unregistered raised livestock which they used were as follows:

Steers—(yearling)	$27.50
Steers—1 year	30.00
Steers—2 years	40.00
Steers—3 years	50.00

creased "cost of goods sold").[3] If Plaintiffs were subject to ordinary income tax in that year, it resulted in increasing the ordinary income tax paid by them. On the other [fol. 6] hand, in the year such animals were sold the amount of income from the sale of the animals that was entitled to long-term capital gain treatment was reduced because Plaintiffs deducted, as a cost basis, the accrued inventory value from the sales price in order to compute the amount of profit to which the long-term capital gain rate would apply.

8. Within the time prescribed by law Plaintiffs duly made and filed with the District Director of Internal Revenue at Austin, Texas, their joint federal income tax returns for the calendar years 1954 and 1955, copies of which returns are attached hereto as exhibits 1(a) and 1(b), respectively.

9. In their joint federal income tax returns the Plaintiffs used as the cost basis of raised breeding herd animals sold during the years 1954 and 1955 the accrued unit values assigned to such animals in Plaintiffs' inventory rather than zero in determining the amount of gain from the sale of raised breeding herd animals under the provisions of Section 1231 of the Internal Revenue Code of 1954.

10. In said returns, in determining their closing inventory for the years 1954 and 1955, Plaintiffs did not make an adjustment to their closing inventory eliminating therefrom the accrued unit value of those raised breeding herd animals sold during the years 1954 and 1955.

11. In said returns, in determining their closing inventory for the years 1954 and 1955, Plaintiffs made an adjustment to their closing inventory in accordance with the applicable Treasury Regulations, whereby new raised [fol. 7] breeding herd animals were included in inventory at a unit value, and the unit value of raised breeding herd animals in inventory was increased.

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[3] Under this method the taxpayers would include in inventory the yearling heifer at $25.00. This would mean an increase in ordinary income of $25.00. As to the same animal, in the following year the value would be increased to $30.00. This increment created a like amount of ordinary income to the extend of $5.00.

12. Thereafter, the Commissioner of Internal Revenue caused Plaintiffs' joint federal income tax returns for the years 1954 and 1955 to be examined and determined that there was a deficiency in income taxes due from Plaintiffs; said deficiency was attributable to adjustments presently not in controversy in this proceeding. On October 17, 1960, Plaintiffs paid to the District Director of Internal Revenue at Austin, Texas, the said deficiency plus statutory interest thereon.

13. On or about July 12, 1961, Plaintiffs duly filed a claim for refund in due and proper form with the District Director of Internal Revenue at Austin, Texas, for the recovery of $7,205.61, for the year 1954, and $46,650-73 for the year 1955, plus statutory interest thereon. A copy of said claim is attached to Plaintiffs' Complaint as Exhibit "A" and incorporated herein by reference as Exhibit "A".

14. Said claim for refund was based in part on the following grounds:

(1) That the applicable Treasury Regulations requiring Plaintiffs to include raised breeding herd animals in inventory are contradictory to the provisions of Section 1231 of the Internal Revenue Code of 1954 and are invalid and of no force and effect.

(2) That in determining taxable income for the years 1954 and 1955 Plaintiffs were entitled to do [fol. 8] the following in order to correct an error caused by the Treasury Regulations:

(a) Use zero as the cost basis of raised breeding herd animals sold during such years rather than the accrued unit value assigned to such animals in determining the amount of gain under the provisions of Section 1231 of the Internal Revenue Code of 1954.

(b) Make an adjustment to their closing inventory for such years eliminating therefrom the accrued unit value of raised breeding herd animals sold during such years.

(c) Make an adjustment to their closing inventory for such years eliminating therefrom the

unit value of those raised breeding herd animals included in inventory for the first time in such years and not sold, and the increase in the unit value of those raised breeding herd animals in inventory from previous years and not sold during such years.

(3) That such adjustments do not constitute a change in accounting methods, and therefore, Plaintiffs were not required to request and obtain the Commissioner's consent thereto.

(4) That it would have been useless for Plaintiffs to file a request to change accounting methods with the Commissioner as no consideration would have been given thereto.

15. More than six months elapsed between the filing of Plaintiffs' claim for refund and the filing of Plaintiffs' [fol. 9] complaint in this proceeding, and the District Director of Internal Revenue neither rejected said claim nor paid it during such period of time.

16. The amount of Federal income taxes involved in this proceeding for the years 1954 and 1955 is $2,118.50 and $14,142.39, respectively. The computation of such amounts is set forth in Appendix I which is attached hereto and made a part hereof.

17. During the years 1954 and 1955 and prior and subsequent thereto up to and including the present time the Commissioner of Internal Revenue did not require inclusion in inventory of raised breeding herd animals on the part of ranchers who maintained breeding herds and kept their books and filed their federal income tax returns on the cash receipts and disbursements method of accounting.

18. During the years 1954 and 1955 and prior thereto Plaintiffs did not file a request to change from the accrual (inventory) method of accounting to the cash receipts and disbursements method with the Commissioner of Internal Revenue and the Commissioner has not consented to a change in accounting methods.

19. During the years 1954, 1955, 1956, 1957, and 1958, it was the policy of the Commissioner of Internal Revenue not to consider requests filed by ranchers to change from

the accrual (inventory) method of accounting for Federal income tax purposes to the cash receipts and disbursements method until the final regulations under the Internal Revenue Code of 1954 were issued.

[fol. 10] 20. Attached as Exhibit "B" is a true copy of a letter from the Secretary of the Treasury dated June 27, 1952, to the Chairman of the Senate Finance Committee. Plaintiffs reserve the right to object to the relevancy or materiality of this document.

FOSTER, LEWIS, LANGLEY
& ONION
Eighteenth Floor Milam Building
San Antonio 5, Texas

By /s/ GORDON G. HAWN
Attorney for Plaintiffs

/s/ JOHN A. BAILEY,
Attorney for Defendant

[fol. 11]

EXHIBIT "B" TO STIPULATION OF FACTS

APPENDIX B

Special Letter of June 27, 1952, from the Secretary of the Treasury to Honorable Walter F. George, Chairman, Senate Finance Committee (1952 C.C.H., Par 6239):

My Dear Senator: The Commissioner of Internal Revenue has called to my attention a tax situation which deserves serious legislative consideration. The problem is of such importance that I feel it should promptly be brought to the attention of the Congressional Committees concerned with taxation. For this reason I am writing to you and am sending a similar letter to Representative Doughton.

The problem arises from a combination of two circumstances:

1. The long-continued administrative practice of permitting farmers to take current expense deductions for the cost of raising livestock held for draft, breeding, or dairy purposes; and

2. The recently developed capital-gain treatment of profits upon the sale of livestock held for those purposes.

Taxpayers have always been required to capitalize, rather than to deduct currently, the cost of buildings, machinery, equipment, and other types of property used in the conduct of a trade or business and subject to the allowance for depreciation. Since livestock used by a farmer for draft, breeding, or dairy purposes is property used in his trade or business
[fol. 12] and subject to the allowance for depreciation, farmers have long been required to capitalize the cost of animals purchased for those purposes.

However, since the early days of the income tax, the regulations have permitted farmers to take current expense deductions for the cost of raising livestock intended for draft, breeding, or dairy purposes. The apparent reason for this regulation, which was introduced before favorable tax treatment had been granted to capital gains, was that the cost of raising

an animal to maturity might be difficult to ascertain, particularly since the Bureau of Internal Revenue did not at that time recognize methods of approximately such costs. Since the sales price of the animal then represented ordinary income the regulation resulted in no loss of revenue to the Government. For more than 20 years after the provisions favoring capital gains were introduced into the income law (in the Revenue Act of 1921), this method continued to produce acceptable results since gain upon the sale of livestock from dairy breeding or breeding herds was consistently treated as ordinary income.

However, the treatment of profits upon the sale of such animals as ordinary income has gradually been departed from in recent years. The first step in this direction was the issuance in 1944 and 1945 of two rulings by the Bureau of Internal Revenue (IT 3666, C. B. 1944, p. 270, and IT 3712, C. B. 1945, p. 176), developed with the assistance of representatives of livestock associations. These rulings granted capital-gains treatment to unusual sales which reduced the
[fol. 13] size of the breeding or dairy herd, but not to routine sales of culled animals. The second step was a series of court decisions, beginning with that in *Albright* v. *United States* (CA-8, 1949), 173 F. 2d 339 [49-1 USTC] [9215], which went beyond the published rulings and extended capital gains treatment to routine sales of animals culled from dairy or breeding herds. The third and latest step was the 1951 legislation sec. 324 of the Revenue Act of 1951, amending sec. 117 (j) (1) of the Internal Revenue Code) designed to restate and clarify the results of the court decisions. This legislation provided that profits from the sale of "livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more" should be eligible for capital-gains treatment.

The interaction of (1) the regulation permitting deduction of costs of raising livestock, added to a dairy or breeding herd and (2) the granting of capital-gains treatment upon the sale of such livestock is

best shown by an example. Assume that a farmer raises to maturity, at a cost of $100 an animals which he places in a dairy or breeding herd. Later the animal is culled from the herd and sold for $150. The farmer's profit is $50, which should be taxed as capital gain. However, the farmer is able to take the $100 cost as a current deduction to offset $100 of otherwise taxable income. If he is using the cash receipts and disbursements method of accounting, the basis of the animal is then treated as zero, and the whole of the sales price (150) is treated as capital
[fol. 14] gain. Only one-half of the sales price, or $75, is included in net income, which is less than the $100 previously deducted. This profitable transaction not only escapes tax completely but is actually permitted to create a tax loss which decreases the amount of the farmer's taxable income from other transactions.

This situation is creating a serious distortion in taxable income. Obviously, the larger the scale of the taxpayer's business, the more serious is the distortion. Applying the figures of the above example to a rancher who adds 200 head of cattle annually to his breeding herd, it will be seen upon computation that the taxpayer's income would be distorted downward by $10,000 annually.

The adverse effect of this situation upon the revenue can be estimated from department of Agriculture statistics which indicate that there are about 44,000,000 mature cows in this country, 23,400,000 being held for dairy purposes and 20,600,000 for the production of beef calves. It would be conservative to estimate that one-eighth of these cows, or 5,500,000 head, are sold annually. If the average cost of raising a cow to maturity is assumed to be $100, the expensing of the cost would distort taxable income downward by $275,000,000 a year. This figure would be increased if pigs, sheep, and other livestock were taken into consideration.

These revenue considerations are important. However, what makes the situation even more serious is that almost intolerable inequities have been created

among farmers and ranchers using different account-
[fol. 15] ing methods. The windfall which has been illustrated is being shared only by those farmers and ranchers who file returns upon the cash receipts and disbursements methods of accounting. This discriminates heavily against farmers and ranchers who use the accrual method of accounting. The general practice of the latter group is to inventory the animals raised for draft, breeding, or dairy purchases at round figures representing the estimated costs normally incurred in raising animals of the particular age and class. Therefore, if the farmer on the accrual basis raises at a cost of $100 an animal for addition to his dairy or breeding herd and later sells the animal for $150, he will pay a tax upon one-half of the gain (that is, upon $25).

The result is that farmers and ranchers using the accrual basis are now paying tax on the true amounts of their capital gains, whereas those on the cash basis are receiving windfalls which not only wipe out their capital gains but also a part of their income from other sources.

In three recent instances the Congress, upon recommendation of your committee, has enacted remedial legislation to prevent actual gains from being converted into tax losses. First, in section 211 of the Revenue Act of 1950, legislation was enacted to prevent short sales from being used for that purpose. Secondly, in section 322 of the Revenue Act of 1951, the method of offsetting short-term and long-term capital gains and losses was changed in order to prevent profits of speculators or investors from taking
[fol. 16] on the appearance of tax losses. Thirdly, in section 323 of the Revenue Act of 1951, the costs of growing unharvested crops which were sold with the land at capital-gain rates were required to be capitalized in order to prevent tax windfalls. The livestock situation falls in this same general category; moreover, the existing inequity between users of the cash basis and users of the accrual basis presents an additional reason for legislative action.

It is estimated that perhaps 75 percent of the cattle ranchers are now on the accrual basis and that a relatively small percentage of the farmers who raise some dairy or breeding cattle are also on that basis. Since the accrual basis reflects income more accurately and is helpful in preventing a bunching of income when the size of the herd is reduced, the Department of Agriculture and the livestock associations have for years been encouraging the use of that method.

However, the windfall now available to users of the cash basis has led to a large and increasing number of requests from farmers and ranchers now on the accrual basis for permission of the Bureau of Internal Revenue to change to the cash basis. In 1951 about 45 such requests were received, all of which were denied. At the present time there are 200 such requests pending and the number continues to grow.

As you know, a taxpayer can change his accounting method only if he receives permission from the Commissioner of Internal Revenue. Obviously, it is the duty of the Commissioner of Internal Revenue to deny the requests of the livestock raisers to change from the accrual to the cash basis, (1) because the [fol. 17] accrual basis now being used by them better reflects their income than the cash basis which they desire to use, and (2) because the requests are not being made for any business reason but solely in order to obtain a tax windfall. Moreover, the change requested by these tax payers is inhibited by the report of your committee upon the Revenue Act of 1951, stating the belief of your committee that gains from sales of livestock should be computed "in accordance with the method of livestock accounting used by the taxpayer and presently recognized by the Bureau of Internal Revenue." For these reasons, it has been decided that, consistent with the action taken upon the requests last year, the sending requests are to be denied.

However, even though it is clearly the Commissioner's duty to deny these requests, this action will prolong the serious inequity which has been described

unless action is taken to eliminate the windfall now being enjoyed by the users of the cash basis. Consideration has been given to elimination of this windfall by an exercise of the administrative authority to prescribe accounting methods. This course of action has been carefully explored in conferences with the representatives of the livestock association and of the Department of Agriculture. However, the conclusion has been reached that administrative action to eliminate the windfall is undesirable in view of the report of your committee referred to above. It has been urged that this report, to the effect that gains from sales of livestock should be computed in accordance with "the method of livestock accounting [fol. 18] used by the taxpayer and presently recognized," prevents amending the regulations to require capitalization of the cost of raising livestock held for draft breeding or dairy purposes.

This Department has given careful consideration to the development of a method of capitalization which will not require detailed record keeping on the part of farmers. It would be feasible to permit farmers to use as their costs for tax purposes a round amount representing the estimated normal cost of raising animals of the particular age and class. This is similar to the so-called unit-livestock-price method of inventory now permitted to accrual basis ranchers and farmers. Once a reasonable figure is established, it could be permitted to remain undisturbed for 5 years or more in the absence of noticeable changes in costs of feed, labor, etc. It is recognized that farmers in different parts of the country may have different costs and the Bureau of Internal Revenue would be expected to permit some tolerance. A farmer who does his own work and raises his own feed would have little, if any, cost to capitalize, since only the outlay of cash or its equivalent would be taken into consideration. All in all, it is believed that this system will present no greater difficulty in bookkeeping than the presently required capitalization

of the cost of purchased animals, farm machinery and equipment, and farm improvements.

Since there is disagreement as to the existence of administrative authority to eliminate the windfall and resulting inequity, legislative action appears to be the wisest course. Therefore, your committee will [fol. 19] need to give consideration to the approval of legislation to require capitalization of the cost of raising livestock held for draft, breeding, or dairy purposes. This would bring the tax treatment of raisers of such livestock who use the cash basis into line with the treatment of those who use the accrual basis and with the treatment of farmers and ranchers who purchase livestock for such use.

In order to avoid retroactive hardship, only future costs of raising animals for draft, breeding, or dairy purposes should be required to be capitalized. For convenience, the new rule might be applied only to taxable years beginning after the date of new legislation. Mature animals in the herd would then retain their existing basis; that is, if they were raised by the taxpayer and a zero basis they will retain that basis. Only the costs of raising the growing animals during future taxable years would be capitalized. In this manner, the taxpayer would gradually change into the new treatment and retain the advantages of whatever basis he had in the past.

In view of the foregoing, it is clear that this matter requires legislative consideration not only for the protection of the revenues but also in the interest of equity among taxpayers. The Department recognizes, however, that because of the complex nature of this problem and the heavy calendar already facing this Congress it may be necessary to defer legislative consideration until early next year. Nevertheless, in view of widespread interest in this matter, it is considered desirable that the Department's position be made known without delay.

JOHN CATTO, JR., AND ROXANA G CATTO
APPENDIX I—SUMMARY OF INCOME TAXES TO BE REFUNDED AS RESULT OF COURT'S FINDING FOR PLAINTIFF ON LEWIS - EKBERG ISSUE

Years 1954 and 1955

	Income Tax Previously Paid - Per RAR	Income Tax Refunded as Result of Settlement of Issues other Than Lewis - Ekberg	Balance	Income Tax as Result of Court's Finding for Taxpayer on Lewis - Ekberg Issue (Appendix Ia and Ie)	Additional Income Tax To be Refunded
Year 1954	5,430.41	3,311.91	2,118.50	—0—	2,118.50
Year 1955	42,867.63	11,997.27	30,870.36	16,727.97	14,142.39
Total income tax to be refunded as result of Court's finding for plaintiff on Lewis - Ekberg issue					16,260.89

[fol. 21]

JOHN CATTO, JR., AND ROXANA G. CATTO
APPENDIX Ia - RECOMPUTATION OF INCOME TAX
LIABILITY AS RESULT OF COURT'S FINDING FOR

PLAINTIFF ON LEWIS - EKERG ISSUE

Year 1954

Taxable income per Revenue Agent's Report dated January 20, 1958		21,086.91
Less:		
(1) Gain on sale of breeding herd animals erroneously treated as ordinary income in Revenue Agent's Report		
Total gain on sale of heifer 1s - per RAR	27,338.76	
Less gain on sales prior to May 1, 1954 - per RAR	6,152.50	
Gain on sale of heifer is erroneously treated as ordinary income in RAR	21,186.26	
50% thereof		10,593.13

Taxable income - before adjustment for correction of inventories (Lewis - Ekberg issue)		
Less:		10,493.78
(2) Decrease in taxable income resulting from correction of inventory of raised breeding herd animal - Appendix Ib		19,329.00
(3) Decrease in taxable income resulting from elimination from cost basis in determining gain on sale of raised breeding herd animals the values assigned to such animals under the unit- livestock-price method of valuing livestock for inventory, and corresponding adjustment to inventory - Appendix Ic	33,945.00	
50% thereof		16,972.50
Plus:		(25,807.72)
(4) Decrease in contributions allowable - Appendix Id		3,587.00
		(22,220.72)
Taxable income (loss) - as adjusted		
Income tax - as adjusted		—0—

JOHN CATTO, JR., AND ROXANA G. CATTO
APPENDIX Ib - DETAIL OF INVENTORY OF LIVESTOCK AT DECEMBER 31, 1954 AND COMPUTATION OF DECREASE IN TAXABLE INCOME RESULTING FROM CORRECTION OF INVENTORY OF RAISED BREEDING HERD ANIMALS

Year 1954

	NUMBER OF HEAD	UNIT VALUATION	TOTAL
Raised breeding herd animals:			
Cows	1,922	35.00	67,270.00
Cows 2s	500	30.00	15,000.00
Heifers 1s	606	25.00	15,150.00
Bulls	23	100.00	2,300.00
Cows - registered	14	100.00	1,400.00
Heifers - registered	9	100.00	900.00
Bulls - registered	20	100.00	2,000.00
Calves - registered	18	50.00	900.00
Ewes	540	5.00	2,700.00

Total raised breeding herd animals - at valuation as reported in income tax return		107,620.00
Other livestock inventories (not at issue)		122,704.54
Total inventory - as reported in income tax return		230,324.54
Decrease in inventory of raised breeding herd animals to arrive at corrected inventory (after 15% discount) - see below		19,329.00
Inventory as corrected - at December 31, 1954		210,995.54

Computation of Decrease in Inventory of Raised Breeding Herd Animals Due to Elimination of Increases and Additions to Unit Valuation in 1954

(1) Valuation of 418 of these cows was erroneously increased by $5 each (from $30 to $35) in determining above inventory - 418 x $5=	2,090.00
(2) Valuation of these 500 cows 2s was erroneously increased by $5 each (from $25 to $30) in determining above inventory - 500 x $5=	2,500.00

(3) These 606 heifer 1s were erroneously included for $25= the first time in above inventory at $25 each - 606 x	15,150.00
(4) Valuation of these 14 cows was erroneously increased by $25 each (from $75 to $100) in determining above inventory - 14 x $25=	350.00
(5) Valuation of these 9 heifers was erroneously increased by $50 each (from $50 to $100) in determining above inventory - 9 x $50=	450.00
(6) Valuation of 2 of these bulls was erroneously increased by $50 each (from $50 to $100) in determining above inventory - 2 x $50=	100.00
(7) These 18 calves were erroneously included in the above inventory for the first time at $50 each - 18 x $50=	900.00

JOHN CATTO, JR., AND ROXANA G. CATTO

APPENDIX Ib - DETAIL OF INVENTORY OF LIVESTOCK AT DECEMBER 31, 1954 AND COMPUTATION OF DECREASE IN TAXABLE INCOME RESULTING FROM CORRECTION OF INVENTORY OF RAISED BREEDING HERD ANIMALS

(continued)

Year 1954

Computation of Decrease in Inventory of Raised Breeding Herd Animals Due to Elimination of Increases and Additions to Unit Valuation in 1954

(continued)

(8) 240 of these ewes were erroneously included for the first time in the above inventory at $5 each - 240 x $5=	1,200.00
Decrease in inventory to arrive at corrected inventory	22,740.00

Less amount discounted (15%)	3,411.00
Decrease in taxable income resulting from correction of inventory of raised breeding herd animals	19,329.00

JOHN CATTO, JR., AND ROXANA G. CATTO
APPENDIX Ic - UNIT VALUES ASSIGNED TO RAISED BREEDING HERD ANIMALS SOLD IN 1954 WHICH QUALIFY UNDER CODE SECTION 1231

	UNIT VALUE ASSIGNED
Raised breeding herd animals sold in 1954 which qualify for capital gain treatment under Code Section 1231:	
682 cows 3s and up	23,870.00
35 cows 2s	1,050.00
12 bulls	1,200.00
313 hiefers 1s	7,825.00
Total	33,945.00

JOHN CATTO, JR., AND ROXANA G. CATTO
APPENDIX Id - RECOMPUTATION OF CONTRIBUTIONS ALLOWABLE

Year 1954

Adjusted gross income per RAR dated January 20, 1958		30,539.35
Less:		
Adjustments thereto:		
Adjustment (1), Appendix Ia	10,593.13	
Adjustment (2), Appendix Ia	19,329.00	
Adjustment (3), Appendix Ia	16,972.50	46,894.63
Adjusted gross income - as adjusted		(16,355.28)
Contributions allowable as adjusted		—0—
Contributions allowable per RAR dated January 20, 1958		3,587.00
Decrease in contributions allowable		3,587.00

JOHN CATTO, JR., AND ROXANA G. CATTO
APPENDIX Ie - RECOMPUTATION OF INCOME TAX LIABILITY AS RESULT OF COURTS FINDING FOR PLAINTIFF ON LEWIS - EKBERG ISSUE

Year 1955

Taxable income per RAR dated January 20, 1958			90,515.51
Less:			
(1) Gain on sale of breeding herd animals erroneously treated as ordinary income in RAR			
Total gain on sale of heifer 1s per RAR	25,010.65		
Less gain on sales prior to May 1, 1955- per RAR	20,950.34		
		4,060.31	
Gain on sale of heifer 1s erroneously treated as ordinary income in RAR	41,515.00		
Total gain on sale of cows 2s per RAR	x 70%	29,060.50	
Gain on sale of breeding herd animals erroneously treated as ordinary income in RAR		33,120.81	
50% thereof			16,560.40

[fol. 30]

Taxable income - before adjustment for correction of inventories (Lewis - Ekberg issue)			73,955.11
Less:			
(2) Decrease in taxable income resulting from correction of inventory of raised breeding herd animals - Appendix If		16,379.50	
(3) Decrease in taxable income resulting from elimination from cash basis in determining gain on sale of raised breeding herd animals the values assigned to such animals under the unit-livestock-price method of valuing livestock for inventory, and corresponding adjustment to inventory - Appendix Ig	25,177.00		
50% thereof		12,588.50	28,968.00
Taxable income - as adjusted			44,987.11
Income tax thereon:			
Ordinary method (joint return)		17,342.39	
Alternative method - not applicable			
Less dividend received credit (per RAR)		614.42	
Income tax - as adjusted		16,727.97	

[fol. 31]

JOHN CATTO, JR., AND ROXANA G. CATTO
APPENDIX If - DETAIL OF INVENTORY OF LIVESTOCK AT DECEMBER 31, 1955, AND COMPUTATION OF DECREASE IN TAXABLE INCOME RESULING FROM CORRECTION OF INVENTORY OF RAISED BREEDING HERD ANIMALS

Year 1955

		NUMBER OF HEAD	UNIT VALUATION	TOTAL
Raised breeding herd animals:				
Cows	(1)	1,598	35.00	55,930.00
Cows 2s	(2)	226	30.00	6,780.00
Heifers 1s	(3)	787	25.00	19,675.00
Cows - registered		14	100.00	1,400.00
Heifers - registered	(4)	34	100.00	3,400.00
Bulls - registered	(4)	33	100.00	3,300.00
Calves - registered	(4)	33	75.00	2,475.00
Calves - registered	(4)	34	50.00	1,700.00
Ewes	(5)	914	5.00	4,570.00

Total raised breeding herd animals - at valuation as reported in income tax return		99,230.00
Other livestock inventories (not at issue)		161,990.00
Total inventory - as reported in income tax return		261,220.00
Decrease in inventory at December 31, 1954, which is also applicable to December 31, 1955, inventory - see below	8,002.75	
Decrease in inventory of raised breeding herd animals to arrive at corrected inventory - see below	27,705.75	35,708.50
Inventory as corrected - at December 31, 1955		225,511.50

[fol. 33]

Computation of Decrease in Closing Inventory of Raised Breeding Herd Animals for Elimination of Increases and Additions to Unit Valuation in 1954 - for Animals Still on Hand at December 31, 1955

Decrease in inventory of raised breeding herd animals at December 31, 1954	22,740.00		
Less amount discounted (15%)	3,411.00	19,329.00	
Less: Animals no longer on hand at December 31, 1955:			
475 cows 2s @ $5	2,375.00		
380 heifers 1s @ $25	9,500.00		
9 heifers @ $50	450.00		
18 calves @ $50	900.00		
20 ewes @ $5	100.00		
	13,325.00		
Less amount discounted (15%)	1,998.75	11,326.25	
Decrease in inventory at December 31, 1954, which is also applicable to December 31, 1955, inventory above - for computation purposes			8,002.75

Computation of Decrease in Inventory of Raised Breeding Herd Animals Due to Elimination of Increases and Additions to Unit Valuations in 1955

(2) Valuation of these 226 cows 2s was erroneously increased by $5 each in determining above inventory- 25 x $5	125.00
(2) Valuation of these 226 2s cows was erroneously increased by $5 each in determining above inventory-	
226 x $5	1,130.00

JOHN CATTO, JR., AND ROXANA G. CATTO
APPENDIX If - DETAIL OF INVENTORY OF LIVESTOCK AT DECEMBER 31, 1955, AND COMPUTATION OF DECREASE IN TAXABLE INCOME RESULTING FROM CORRECTION OF INVENTORY OF RAISED BREEDING HERD ANIMALS

(continued)

Year 1955

Computation of Decrease in Inventory of Raised Breeding Herd Animals Due to Elimination of Increases and Additions to Unit Valuations ni 1955 (continued)

(3)	These 787 heifers 1s were erroneously included for the first time in above inventory at $25 each - 787 x $25	19,675.00
(4)	These registered animals were erroneously included for the first time in above inventory at $100 each -	

34 x $100	3,400.00		
20 x $100	2,000.00		
33 x $75	2,457.00		
34 x $50	1,700.00		
(5) 418 of these ewes were erroneously included for the first time in above inventory at $5 each - 418 x $5	2,090.00		
Decrease in inventory to arrive at corrected inventory	32,595.00		
Less amount discounted (15%)	4,889.25		
Decrease in closing inventory to arrive at corrected inventory for computation purposes		27,705.75	
Total decrease in closing inventory for computation purposes		35,708.50	
Less decrease in opening inventory - per Appendix Ib		19,329.00	
Decrease in taxable income resulting from correction of inventory of raised breeding herd animals			16,379.50

JOHN CATTO, JR., AND ROXANA G. CATTO
APPENDIX Ig - UNIT VALUES ASSIGNED TO RAISED BREEDING HERD ANIMALS SOLD IN 1955 WHICH QUALIFY UNDER CODE SECTION 1231

		UNIT VALUES ASSIGNED
Raised breeding herd animals sold in 1955 which qualify for capital gain treatment under Code Section 1231:		
276 cows 3s and up		9,660.00
38 cows 2s		1,140.00
30 bulls		3,000.00
4 heifers (registered)		400.00
72 heifers 1s		1,800.00
437 cows 2s	13,110.00	
	x 70%	9,177.00
Total		25,177.00

[fol. 38]

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

Civil Action No. 3060

JOHN CATTO, JR. AND ROXANA CATTO, his wife

v.

UNITED STATES OF AMERICA

FINDINGS OF FACT AND CONCLUSIONS OF LAW—
September 30, 1963

The above-entitled action was brought by Plaintiffs against Defendant for the recovery of income taxes and interest thereon heretofore assessed against and collected from Plaintiffs by Defendant. After the Defendant answered the Plaintiffs and Defendant made and entered into stipulations of fact. There being no dispute as to any material fact and the suit involving a question of law, the case came on for trial in the United States District Court for the Western District of Texas, San Antonio Division, on the 3rd day of May, 1963, for oral argument and submission to the Court. The Court having considered the Stipulation of Facts entered into between the Plaintiffs and Defendant, the briefs submitted to the Court by the parties, and the arguments of counsel, upon the entire record, now makes the following findings of fact and conclusions of law:

FINDINGS OF FACT

(1) All the material facts herein have been stipulated and the Stipulations of Facts entered into between Plaintiffs and Defendant are hereby found as stipulated and incorporated herein.

[fol. 39] (2) This action is for the recovery of income taxes and interest herefore assessed against and collected from Plaintiffs by Defendant and is brought under Title 28, U. S. Code Ann., Section 1346 (a) (1) as amended and under the Internal Revenue Code of 1954.

(3) Plaintiffs are husband and wife and at all times material hereto were residents of Bexar County, City of San Antonio, State of Texas.

(4) During the years 1954 and 1955 (the years involved in this proceeding) and for many years prior thereto, Plaintiffs were engaged in the ranching business. In connection therewith Plaintiffs owned and operated two ranches in West Texas. One ranch, which is located in Brewster County, is known as the Marathon Ranch and consists of approximately 173,000 acres. The other ranch, which is located in Presidio County, is known as the Marfa Ranch and consists of approximately 20,000 acres.[1]

[fol. 40] (5) The ranching business conducted by Plaintiffs consisted of breeding and raising cattle for the production and sale of calves. Customarily the animals sold by the Plaintiffs are sent to the Midwest by purchasers for fattening and ultimate sale for beef or slaughter pur-

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[1] These ranches were originally owned by Plaintiff-Roxana Catto's father and mother, Mr. and Mrs. A. S. Gage. In 1924 Mrs. Gage died and devised her community one-half interest in the community estate in trust for the benefit of her two daughters (Plaintiff-Roxana Catto and her sister) with her husband as trustee. Thereafter the ranches were operated as an informal partnership by Mr. Gage in his capacity as trustee for his two daughters under Mrs. Gage's will and in his individual capacity. In 1928 Mr. Gage died; under his will his interest in the ranches was devised, in trusts for ten years for the benefit of his two daughters (Plaintiff-Roxana Catto and her sister). The trustees operated the ranches as a partnership until 1938 when the trusts and partnership were terminated. Thereafter, Plaintiff-Roxana Catto, her sister and their respective husbands operated the ranches as a partnership. On December 31, 1948 the partnership operations at the Marathon Ranch were terminated and equally divided between the daughters, and thereafter, each daughter owned and operated a separate ranch at Marathon. On December 31, 1951, the partnership operations at the Marfa Ranch were terminated and equally divided between the two daughters who thereafter operated their respective portions separately.

poses. In connected with the ranching business Plaintiffs maintained a breeding herd of Hereford cattle. As circumstances required, Plaintiffs purchased bulls and cows for addition to their breeding herd, to increase the herd, improve the quality and prevent in breeding. Also as circumstances required, the Plaintiffs selected certain calves produced from the breeding herd and added the same thereto. The number of animals to be retained in the breeding herd was determined on the basis of range conditions, rainfall, costs of operation and other factors. When required by age, disease and other circumstances, the Plaintiffs culled from the breeding herd and sold animals which were unfit for breeding stock or which for some other reason could not be retained. Calves produced by the breeding herd and not added to the breeding herd were sold in the due course of business.

(6) For each of the years here involved, Plaintiffs kept their books and records and filed their federal income tax returns on the accrual (inventory) and calendar year basis, and used the unit-livestock-price method of valuing inventory. Plaintiffs, either as member of a partnership operating the ranches or as sole proprietors, have been using the accrual (inventory) method for keeping [fol. 41] their books and records and valuing inventory under the unit-livestock-price method since 1938.[2]

(7) Under Treasury Regulation 1.471.6 (f), (and its predecessors), a taxpayer valuing inventory under the unit-livestock-price method is required to include raised breeding animals as well as animals held for sale in the ordinary course of business in inventory at a unit value. Under said Treasury Regulation (and its predecessors)

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[2] This method was first adopted by Plaintiff-Roxana Catto's father and mother in approximately 1920 and was continued by the various partnerships which operated the ranches until 1938. When Plaintiff-Roxana Catto, her sister and their respective husbands commenced operating the ranches as a partnership they continued to use this method; and when the partnership operations were terminated and the Plaintiffs began operating their part of the ranches as a sole proprietorship at the end of 1948 and 1951 they continued to use this method.

as such animals advance in age the taxpayer is required to increase the unit values thereof.[3]

(8) For each of the years here involved as well as for each of the years prior thereto, Plaintiffs as required by the Treasury Regulations included their raised breeding animals in their inventory along with animals raised and held for sale in the ordinary course of business and valued such raised breeding animals under the unit-livestock-price method in accordance with the Treasury Regulations.

[fol. 42] (9) For each of the years here involved as well as for each of the years prior thereto, the inclusion of raised breeding animals in Plaintiffs' livestock inventory as required by the Treasury Regulations, and the valuation thereof under the unit-livestock-price method as provided in the Treasury Regulations resulted in increasing Plaintiffs' ordinary income for each of such years in an amount equal to the unit value assigned to each new raised breeding animal included in inventory for the first time, plus an amount equal to the annual increase in unit value for the raised breeding animals previously included in inventory.[4] If Plaintiffs were subject to ordinary income tax in that year, it resulted in increasing the ordinary income tax paid by them. On the other hand,

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[3] The kinds, classifications, categories and unit values assigned to raised breeding herd animals during the years 1954 and 1955 and prior thereto were as follows:

NON-REGISTERED		REGISTERED	
Heifer yearlings	$ 25.00	Calves	$ 30.00
Cows, two-year-old	30.00	Heifer yearlings	75.00
Cows, three-year-old	35.00	Cows	100.00
Bulls	100.00	Bulls	100.00

The partnership between Plaintiff-Roxana Catto, her sister and their respective husbands began using these particular unit values on January 1, 1942, and continued to use them throughout the duration of the partnership. When Plaintiffs commenced operating the ranches as a sole proprietorship they used the same unit values.

[4] Under this method the Plaintiffs would include in inventory the yearling heifer at $25.00. This would mean an increase in ordinary income of $25.00. As to the same animal, in the following year the value would be increased to $30.00. This increment created a like amount of ordinary income to the extent of $5.00.

in the year such animals were sold the amount of profit from the sale that was entitled to capital gain treatment was reduced because Plaintiffs were required to deduct, as the cost basis, the accrued inventory value from the sales price in order to compute the amount of profit to which the capital gain rate would apply.

(10) During the years involved herein, and prior and subsequent thereto up to and including the present time, the Commissioner of Internal Revenue did not, and does not, require ranchers who maintain breeding herds and file their Federal tax returns on the cash receipts and disbursements basis to include raised breeding herd animals in inventory.

[fol. 43] (11) In each of the years here involved, as well as in the previous years, Plaintiffs culled and sold from their breeding herd, animals (including raised animals) which had been held and used by them for breeding purposes and had been held my them for more than twelve months before the date of such sales but which were unfit for breeding purposes or which for other reasons were not suitable or desirable for retention in their breeding herds.

(12) In filing their Federal income tax returns for each of the years here involved, the Plaintiffs, in determining the amount of gain from the sale of raised animals which had been held and used by them for breeding purposes and had been held by them for more than twelve months before the date of such sales, used the accrual unit inventory value assigned to such animals as the basis. In filing said returns, plaintiffs, also in accordance with the applicable Treasury Regulations, included new raised breeding herd animals in inventory at a unit value and increased the unit value of raised breeding herd animals in inventory.

(13) The Commissioner of Internal Revenue caused Plaintiffs' Federal income tax returns for the years here involved to be examined and determined that there was a deficiency in income taxes due from plaintiffs; said deficiency was attributable to adjustments presently not in controversy in this proceeding. On October 17, 1960, Plaintiffs paid to the District Director of Internal Revenue at Austin, Texas, the said deficiency plus statutory interest thereon.

(14) Thereafter, Plaintiffs duly filed claims for re-
[fol. 44] fund in due and proper form with the District Director of Internal Revenue at Austin, Texas, for the recovery of income taxes overpaid for the years involved herein. Said claim was neither rejected nor paid and after the expiration of six months Plaintiffs filed the complaint in this proceeding.

(15) During the years involved herein Plaintiffs did not file a request to change from the accrual (inventory) method of accounting to the cash receipts and disbursement method with the Commissioner of Internal Revenue. During such years the Commissioner would not consider a request of a rancher or farmer to change from the accrual (inventory) method of accounting to the cash receipts and disbursements.

(16) In their claims for refund and in this proceeding Plaintiffs claim:

> 1. That Treasury Regulation Section 1.471-6(f), and its predecessor, requiring Plaintiffs to include raised breeding herd animals in inventory, are contradictory to Section 1231 of the Internal Revenue Code of 1954 which provides that livestock held for draft, dairy or breeding purposes constitutes property used in the trade or business, and that they are, therefore, invalid and of no force and effect.
>
> 2. That Plaintiffs are entitled to remove from inventory raised breeding animals included in inventory in compliance with the said Treasury Reg-
> [fol. 45] ulation in order to correct an error caused by the Regulation.[5]

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[5] The removal of such animals from inventory would be accomplished by:

(1) Adjusting closing inventory in the years involved eliminating therefrom an amount equal to the accrued unit value of raised breeding animals sold during such years; and,

(2) Adjusting closing inventory in the years involved eliminating therefrom the unit value of those raised breeding herd animals involved in inventory for the first time in such years and not sold, and the increase in the unit value of those raised breeding herd animals in inventory from previous years and not sold during such years.

3. That Plaintiffs are entitled to use zero as the basis of breeding animals sold during such years rather than the accrued unit value assigned to such animals in determining the amount of gain under the provisions of Section 1231 of the Internal Revenue Code of 1954.

4. That the correction of the error cause by the invalid Treasury Regulation does not constitute a change of accounting method, and therefore, Plaintiffs were not, and are not, required to obtain the consent of the Commissioner.

5. That even if a change of accounting method is involved, the law does not require a taxpayer to do a useless thing by applying to the Commissioner to change an item when the Commissioner arbitrarily refuses to consider and act upon such applications.

6. That the decision of the United States Court of Appeals for the Fifth Circuit in the case of *Scofield* v. *Lewis*, 251 F.2d 128, holding the Regulation in question invalid is controlling in this case.

(17) All findings of facts deemed conclusions of law are hereby adopted as conclusions of law.

[fol. 46] CONCLUSIONS OF LAW

From the foregoing facts the Court concludes as follows:

(1) This Court has jurisdiction of the subject matter of this action and the parties.

(2) In filing their Federal income tax returns for the years here involved, Plaintiffs erroneously, but in compliance with the provisions of Treasury Regulation Section 1.471-6(f), included within their inventory of livestock raised breeding animals which constituted a part of the breeding herd and which were held for breeding purposes. *Scofield* v. *Lewis*, 251 F.2d 128, affirming the decision of the United States District Court, Western District of Texas, 57-1 U.S.T.C. par. 9251.

(3) Section 1231 of the Internal Revenue Code clearly and unequivocally states that livestock held for breed-

ing purposes is property used in the trade or business of the taxpayer. As to such livestock, the taxpayers were not required to include them in inventory, or to use a unit-livestock-price method to determine the cost basis of animals sold. *Scofield* v. *Lewis supra*, at page 132.

(4) Treasury Regulation 1.471-6(f), and specifically the portion thereof requiring the inclusion of breeding herd animals in a ranchman's inventory, is violative of, and is in conflict with Section 1231 of the Internal Revenue Code and is therefore, invalid; consequently, the Plaintiffs should not have been compelled to include their raised breeding herd animals in inventory. *Scofield* v. *Lewis*, supra.

[fol. 47] (5) The so-called rule that re-enactment of a statute gives the force of law to a prior regulation interpreting the statute is not applicable in this case (a) because the Defendant has failed to establish that Congress had general or specific knowledge of the portion of the regulations in question;[6] (b) because the portion of the regulations in question was not in fact a construction or interpretation of the statute but was an invalid provision in conflict with that statute, and (c) because the statute in question is clear and unequivocal and therefore the rule of re-enactment is not pertinent.[7]

(6) Plaintiffs are entitled to remove from inventory raised breeding animals included in inventory in compliance with the said Treasury Regulation in the manner claimed in order to correct an error caused by the Regulation. *Scofield* v. *Lewis*, supra.

(7) Plaintiffs are entitled to use zero as the basis of breeding animals sold during the years involved herein rather than the accrued unit values assigned to such animals in determining the amount of gain under the provisions of Section 1231 of the Internal Revenue Code 1954. *Scofield* v. *Lewis*, supra.

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[6] See Mertens Law of Federal Income Taxation, Vol. 1, Sec. 3.24 Pages 49 and 51.

[7] See Mertens. supra, at page 48, where it is stated that "The doctrine (of statutory re-enactment) has no application where the law itself is plain and needs no administrative construction. . ."

(8) Section 446(e) of the Internal Revenue Code of 1954 and the Regulations applicable thereto, requiring the consent of the Commissioner of Internal Revenue to any change in accounting method have no application to a situation where a taxpayer seeks to remove from inven-[fol. 48] tory items which, under the statute, qualify as property used in the trade or business, and which were improperly required by an invalid regulation to be included in inventory in the first place. Inasmuch as this removal does not involve a change of accounting method, neither the approval nor the consent of the Commissioner is required. In this situation, methods of accounting are not determinative of the tax liability, and for this reason neither approval nor consent of the Commissioner is required. *Scofield* v. *Lewis*, supra.

(9) The decision of the United States Court of Appeals for the Fifth Circuit in *Scofield* v. *Lewis*, supra is controlling here.

(10) Plaintiffs' selection of the accrual (inventory) method of accounting and the unit-livestock-price method of valuing inventory when they commenced operating the ranches as a partnership in 1938 was not a meaningful choice, as at that time the statute did not authorize capital gains treatment on livestock used for draft, dairy or breeding purposes. It was not until 1951 that Congress specifically authorized capital gains treatment on livestock by amending Section 117(j) of the 1939 Code; and it was not until January 20, 1958 that the Court of Appeals for the Fifth Circuit decided the case of *Scofield* v. *Lewis*, supra. Thus, in any event, Plaintiffs did not have a knowledgeable choice as to accounting methods when they began operating their ranches as sole proprietorships, or when they filed their income tax returns for 1954 and 1955, and they have validly and timely corrected the error in their inventory practices resulting from the invalid regulation.

[fol. 49] (11) Any conclusion of law deemed a conclusion of fact is hereby adopted as a finding of fact.

(12) Judgment shall be entered for the Plaintiffs for the amounts stipulated to be in controversy, together with costs.

Dated at San Antonio, Texas the 30th day of September, 1963.

/s/ ADRIAN A. SPEARS
/s/ ADRIAN A. SPEARS
United States District Judge

[fol. 50]

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

CIVIL ACTION

No. 3060

JOHN CATTO, JR. and ROXANA CATTO, his wife

v.

UNITED STATES OF AMERICA

JUDGMENT—October 15, 1963

The above entitled action having come on regularly for trial in the United States District Court at San Antonio, Texas, on the 3rd day of May, 1963, upon an agreed stipulation of facts, and the Court having heard the argument of counsel, and considered the briefs of counsel, and the Court having heretofore made and entered its findings of fact and conclusions of law, and the Court being otherwise fully advised in the premises, and for good cause shown, now, therefore, it is hereby

ORDERED, ADJUDGED and DECREED that the Plaintiffs have and recover from the Defendant the sum of TWO THOUSAND ONE HUNDRED EIGHTEEN AND 50/100 DOLLARS ($2,118.50), with interest thereon at six per cent (6%) per annum from April 15, 1955,

to a date not more than thirty (30) days from the date of payment, and the sum of FOURTEEN THOUSAND ONE HUNDRED FORTY-TWO AND 39/100 DOLLARS ($14,142.39) with interest thereon at six per cent (6%) per annum from April 15, 1956, to a date not more than [fol. 51] thirty (30) days from the date of payment, together with the costs of this action to be taxed by the Clerk of this Court.

SIGNED AND ENTERED this the 15th day of October, A.D. 1963.

/s/ ADRIAN A. SPEARS
/s/ ADRIAN A. SPEARS
United States District Judge

[fol. 52]

* * * *

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

CIVIL ACTION

No. 3060.

JOHN CATTO, JR. AND ROXANA CATTO, his wife, PLAINTIFFS

vs.

UNITED STATES OF AMERICA, DEFENDANT

NOTICE OF APPEAL

Notice is hereby given that the defendant herein hereby appeals to the United States Court of Appeals for the Fifth Circuit from the final judgment entered in this action on the 15th day of October, 1963.

ERNEST MORGAN
United States Attorney

By: /s/ HARRY LEE HUDSPETH
Assistant U. S. Attorney
Post Office Box 1701
San Antonio, Texas

CERTIFICATE OF SERVICE BY MAIL

This is to certify that a copy of the foregoing Notice of Appeal has been served on opposing counsel by depositing a copy of same in the United States Mails, postage prepaid, addressed to Mr. Gordon G. Hawn, Attorney at Law, 18th Floor Milam Building, San Antonio, Texas, on this, the 12th day of December, 1963.

/s/ HARRY LEE HUDSPETH
Assistant U. S. Attorney

[fol. 53] * * *

[fol. 54]

IN UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MINUTE ENTRY OF ARGUMENT AND SUBMISSION—
December 7, 1964

[Omitted in Printing]

[fol. 55]

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 21351

UNITED STATES OF AMERICA, APPELLANT

versus

JOHN CATTO, JR., and ROXANA CATTO, his wife, APPELLEES

Appeal from the United States District Court for the Western District of Texas.

OPINION—April 8, 1965.

Before GEWIN and BELL, Circuit Judges, and McRAE, District Judge.

PER CURIAM: This appeal raises once again the problem of the tax and accounting treatment to be accorded raised breeding cattle which are sold by an accrual basis taxpayer.[1] The appellees, who are owners [fol. 56] and operators of two cattle ranches in West Texas, keep their books on the accrual basis and file their tax returns accordingly.

Taxpayers, in conformity with Treasury regulations,[2] have chosen to value their inventory by the unit-livestock-price method. If this method is used, standard unit values are assigned to different classes of animals within the herd, representing estimated rather than actual expenses of raising each animal, and standard increments

[1] The identical issue is raised in United States v. Wardlaw, No. 21607, ... F.2d ....., decided this day.

[2] Treas. Reg. 1.471-6(c).

are added to closing inventory each year. Under Treas. Reg. 1.471-6(f), a taxpayer who elects to use the unit-livestock-price method of valuing his inventory must apply it to all of his *raised* livestock, whether they are held for sale or for breeding purposes. Hence, an accrual taxpayer who employs the unit-livestock-price method must include his raised breeding cattle in inventory along with his cattle held for sale, although the breeding cattle may be taxed at capital gains rates upon sale.[3]

Prior to and during the taxable years in question, the taxpayers complied with Treas. Reg. 1.471-6(f). They removed the raised breeding cattle which they sold from opening and closing inventory for the year of sale and paid a capital gains tax on the sales, using the inventory value under the unit-livestock-price method as the basis for computing the gain on the sale of each animal.

Taxpayers then instituted this suit for refund in the district court, contending, on the basis of our decision [fol. 57] in *Scofield* v. *Lewis*, (5 Cir. 1958) 251 F.2d 128, that Treas. Reg. 1.471-6(f) is invalid and that they may therefore correct the erroneous inclusion of raised breeding cattle in inventory by removing all such cattle from closing inventory. This procedure, in effect, affords them a deduction of the estimated raising costs against ordinary income, but they must compute the gain on the sale of these cattle on a zero basis. The net effect of this transaction is to substitute a deduction against ordinary income for a deduction against capital gains. The district court, following *Scofield*, ruled in favor of the taxpayers.

The Government challenges the propriety of applying the *Scofield* rationale, urging that the requirement that raised breeding cattle be inventoried is merely a convenient means of capitalizing the cost of such cattle until the time of sale and, as such, is a valid exercise of the Commissioner's power to prescribe accounting methods which accurately reflect income. The taxpayers, on the other hand, note the discriminatory effect of this requirement on accrual taxpayers, since the Treasury has long indulged similar cash basis taxpayers by allowing them to write off the raising costs of breeding cattle against

[3] 26 U.S.C.A. § 1231(b)(3).

ordinary income and compute their capital gain on the sale of such cattle on a zero basis. They argue that *Scofield* was correct in holding that Treas. Reg. 1.471-6 (f) is inconsistent with section 1231(b)(3), which accords all breeding cattle capital gains treatment. While we are fully cognizant of the anomaly of allowing such tax treatment of a capital asset and appreciate the appealing con- [fol. 58] ceptual arguments of the Government, we regard *Scofield* as controlling until its legislative or judicial demise.[4]

Since *Scofield* governs on the issue of the invalidity of Treas. Reg. 1.471-6(f), we think the taxpayer is justified in correcting the error which the regulation imposed by the procedure which he suggests, even though it results in an inordinate deduction against ordinary income in the year in which the correction is made. Moreover, we do not deem this a change in accounting method which necessitates the consent of the Commissioner, particularly in view of the consistent refusal of the Commissioner, during the years in question, to entertain applications by accrual basis cattle ranchers to change to the cash method of accounting for tax purposes.[5]

Accordingly, the judgment is AFFIRMED

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[4] We are also aware of the fact that the two Circuits that have examined the problem since the *Scofield* decision have refused to follow it, see Little v. Commissioner (9 Cir. 1961) 294 F.2d 661; United States v. Ekberg (8 Cir. 1961) 291 F.2d 913, *cert. denied*, 368 U.S. 920, 7 L.Ed.2d 135, and that this Court has severely limited its applicability, see Carter v. Commissioner (5 Cir. 1958) 257 F.2d 595, which relates to purchased breeding animals inventoried on the farm-price method.

[5] It was stipulated that during the years 1954-1958, the Commissioner refused to consider ranchers' requests to change from accrual accounting methods to the cash receipts and disbursements method. A similar situation obtained during the years 1946-1949, as indicated by *Scofield* v. *Lewis*, 251 F.2d at 131. The taxpayer, therefore, feels he cannot escape from the "Box" in which his election has placed him.

[fol. 59]

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term, 1964

No. 21351

D. C. Docket No. C. A. 3060

UNITED STATES OF AMERICA, APPELLANT

versus

JOHN CATTO, JR., AND ROXANA CATTO, HIS WIFE, APPELLEES

Appeal from the United States District Court for the Western District of Texas.

Before GEWIN and BELL, Circuit Judges, and M RAE, District Judge.

JUDGMENT—April 8, 1965

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

Issued as Mandate: May 3, 1965

[fol. 60]

[Clerk's Certificate to foregoing transcript omitted in printing]

[fol. A] [File Endorsement Omitted]

[fols. 1-2] * * *

[fol. 3]

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
DEL RIO DIVISION

CIVIL ACTION
No. 306

W. H. WARDLAW, independent Executor of the Estate of C. W. Wardlaw, Deceased, et al
vs.
UNITED STATES OF AMERICA

CIVIL ACTION
No. 307

W. H. WARDLAW and wife, MATTYE GWEN WARDLAW
vs.
UNITED STATES OF AMERICA

CIVIL ACTION
No. 328

W. R. WHITEHEAD and wife, DORA WHITEHEAD
vs.
UNITED STATES OF AMERICA

CIVIL ACTION
No. 329

F. H. WHITEHEAD and wife, WINNIE WHITEHEAD
vs.
UNITED STATES OF AMERICA

CIVIL ACTION
No. 330

L. D. WHITEHEAD
vs.
UNITED STATES OF AMERICA

CIVIL ACTION

No. 331

F. J. BARRETT and wife, ALMA BARRETT

vs.

UNITED STATES OF AMERICA

[fol. 4]

CIVIL ACTION

No. 332

R. W. HODGE, and wife, ANALE HODGE

vs.

UNITED STATES OF AMERICA

CIVIL ACTION

No. 333

B. E. WILSON and wife, ELSIE WILSON

vs.

UNITED STATES OF AMERICA

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above entitled actions were brought by Plaintiffs against Defendant for the recovery of income taxes and interest thereon heretofore assessed against and collected from Plaintiffs, respectively, by Defendant. After Defendant answered in each of such causes, all of the issues involved therein with respect to the determination of Plaintiffs' inventory of livestock and the calculation of gain upon the sale of livestock held for breeding purposes were upon motion of Plaintiffs and by order of this Court, severed from the other issues involved in such actions for trial separately by the Court without a jury. Plaintiffs, respectively, and Defendant having made and entered into stipulations of fact, Plaintiffs filed their respective Motions for Summary Judgment with relative to raised animals held for breeding, purposes, and with respect to purchased animals held for breeding purposes. Defendant also filed its Motions for Summary Judgment.

There being no dispute as to any material fact, and these suits involving common question of law, the above entitled actions were consolidated for purposes of briefing, argument and trial and came on for trial jointly in the United [fol. 5] States District Court for the Western District of Texas, Del Rio Division, sitting in San Antonio, Texas, on the 3rd day of May, 1963, for oral argument and submission, and the Court having considered the Stipulations of Facts entered into between Plaintiffs and Defendant, the briefs submitted by the parties in support of their respective Motions for Summary Judgment, and the arguments of counsel, upon the entire record, now makes the following findings of fact and conclusions of law:

Findings of Facts

(1) These suits are for the recovery of income taxes and interest heretofore assessed against and collected from Plaintiffs by Defendant and are brought pursuant to the provisions of Sec. 1346(a)(1) of Title 28 of the United States Code Act of June 25, 1948, Chapter 646, 62 Stat. 869, as amended by Act of July 30, 1954, Chapter 648, Sec. 1, 68 Stat. 589.

(2) Each of these cases raises the following questions:

1. With regard to raised breeding animals:

   (a) Whether that portion of Regulation 1.471-6 (f) which requires the inclusion of raised livestock held and used by Plaintiffs for breeding purposes in their inventory of livestock and the valuation thereof under the unit-livestock-price method is in conflict with or restrictive of the provisions of Section 1231 of the Internal Revenue Code, and therefore invalid.

[fol. 6] (b) Whether the Plaintiffs are required to obtain the Commissioner's consent, in accordance with Section 446(e) of the Internal Revenue Code, to remove from inventory breeding animals which under Sec. 2131 of the Internal Revenue Code qualify as property used in trade or business and which were required by Regulation

1.471-6(f) to be included in inventory in the first place.

(c) Whether the cost basis to be used in computing capital gain on the sale of raised breeding animals sold is zero.

2. With regard to purchased breeding animals:

(a) Whether animals purchased for draft or breeding purposes after animals previously purchased had been included in inventory, may be treated as capital assets subject to depreciation after maturity during the years in question.

(b) Whether the cost basis to be used in computing the capital gain on the sale of purchased breeding livestock sold is the cost thereof less depreciation.

(3) All the material facts herein have been stipulated and the Stipulation of Facts entered into between Plaintiffs, respectively, and Defendant are hereby found as stipulated and incorporated herein.

(4) Plaintiffs have been engaged in the business of ranching in the capacities and from the times set opposite their names below and were so engaged during the years here involved, also set opposite their names below:

[fol. 7]

Civil Action	Plaintiffs	Capacity	Dates of Commencement of Ranching Business	Years Involved
306	C. W. WARDLAW, now deceased, (W. H. Wardlaw, Executor)			
307	and W. H. WARDLAW	Partnership	1935	1955-1959
328	W. R. WHITEHEAD	Sole Proprietorship	1927	1957-1959
329	F. H. WHITEHEAD	Sole Proprietorship	1927	1957-1959
330	L. D. WHITEHEAD	Sole Proprietorship	1927	1957-1959
331	F. J. BARRETT	Sole Proprietorship	1917	1958-1959
332	W. R. HODGE	Sole Proprietorship	1941	1958-1959
333	B. E. WILSON	Sole Proprietorship	Prior to 1913	1958-1959
		and Partnership	1948	1958-1959

[fol. 8] (5) The ranching businesses conducted by Plaintiffs since the time of commencement thereof and during the years here involved, as above stated, consisted of breeding and raising sheep, goats and cattle principally for the production of wool, mohair, mutton and calves. Plaintiffs maintained breeding herds of sheep, goats and cattle for use in connection with their ranching businesses. As circumstances required, Plaintiffs purchased bucks, ewes, billies, nannies, bulls and cows for addition to their breeding herd to increase their herds, improve the quality and prevent inbreeding. Also, as circumstances required, Plaintiffs selected certain lambs, kids and cows produced from the breeding herd and added same to the breeding herd. The number of animals to be retained in the breeding herd was determined on the basis of range conditions, rainfall, cost of operation and other factors. When required by age, disease, or other circumstances, Plaintiffs culled from their breeding herd certain animals which were held for breeding purposes but which were unfit for breeding stock or which for some other reason could not be retained and same were sold. Lambs, kids and calves produced by the breeding herd and not added to the breeding herd, as well as wool and mohair produced by the breeding herd were sold in due course of business. Plaintiffs also maintained a herd of stallions, mares and saddle horses which were used in conducting their ranching business.

(6) Each of Plaintiffs had the right to select his method of accounting *when he commenced business*, and each Plaintiff did select the accrual inventory method of accounting at that time. However, such selection as to raised animals was not a meaningful free choice, or, as [fol. 9] the Defendant puts it, not an "enlightened free choice," because the selection was made prior to the time that it had become clear, under applicable statutes, regulations and litigated cases, that the selection of one method of accounting would produce capital gains on the appreciation in value of raised breeding animals and the selection of another method would produce ordinary income. The first possible time that Plaintiffs could have had full and complete knowledge of their right to make a choice as to accounting methods would have been for the taxable

year 1957, which was after the decision in *Scofield* v. *Lewis* was rendered on January 20, 1958, and they have made their election as to 1957, and all subsequent years, within the time allowed them by the three year statute of limitations in the tax laws.

(7) In 1942, Section 117(j), which provided for capital gains treatment for "property used in the trade or business," was added to the Internal Revenue Code of 1939 by Section 151(b) of the Revenue Act of 1942. There was nothing in the Internal Revenue Code of 1939 as originally enacted, nor in any prior Revenue Act, relating to property used in the trade or business, corresponding to Section 117(j). In 1951, Section 117(j) of the Internal Revenue Code of 1939 was amended by Section 324 of the Revenue Act of 1951 to provide specifically that the term "property used in the trade or business * * * includes livestock, regardless of age, held by the taxpayer for draft, breeding or dairy purposes * * *." Thereafter, Section 117(j) of the Internal Revenue Code, as amended by the Revenue Act of 1951, was re-enacted, without any consequential change, as Section 1231 of the [fol. 10] Internal Revenue Code of 1954, the language of which is clear and unequivocal and the intent of which is plain.

(8) From the time they commenced business, as above stated, until 1944, Plaintiffs each valued their livestock inventories under the "constant unit-price" method. In December, 1944, Regulation 111, Sec. 29.22(c)-6 was amended by TD 5423, 1945 CB 70, to provide that:

> "A livestock raiser who had for taxable years beginning prior to January 1, 1944, adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the 'unit-livestock-price method'."

Therefore, Plaintiffs were in 1944 required by the Commissioner's Regulation to follow the "unit-livestock-price-method" of valuing inventories.[1]

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[1] Regulation 111, Sec. 29.22(c)-6, as amended by TD 5423, was succeeded by Regulation 118, Sec. 39.22(c)-6 and Regulation 1.471-6,

(9) T.D. 5423, supra, further amended Regulation 111, Sec. 29.22(c)-6, to provide that:

> "A taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised, whether for sale or for breeding, draft or dairy purposes."

Therefore, Plaintiffs, in 1944, were also required by the Commissioner's Regulation to include their raised breeding animals in their livestock inventories along with animals raised and held for sale on the market.

[fol. 11] (10) During the years here involved each of the Plaintiffs, except Plaintiffs B. E. WILSON, R. W. HODGE and F. J. BARRETT, as required by the Commissioner's Regulations, included their raised breeding animals in their inventory along with animals raised and held for sale on the market and valued such raised breeding animals under the unit-livestock-price method pursuant to and in accordance with the Regulations. Plaintiffs B. E. WILSON, R. W. HODGE and F. J. BARRETT did not include their raised breeding animals in their inventories in the years 1957, 1958 and 1959.[2]

(11) As a result of the foregoing requirements of the Regulations that these Plaintiffs use the unit-livestock-price method and include raised breeding animals in inventory, the initial inventory value of raised breeding animals put in inventory was taxed as ordinary income, and all annual increases thereafter in the inventory value of such raised breeding animals were also taxed as ordinary income.

(12) Although Treasury Regulation 1.471-6(g), and its predecessors, did not require the taxpayers to do so, they voluntarily elected to include their purchased breeding animals in inventory, rather than capitalize them, for each year beginning with the inception of their busi-

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which contained the same language set forth in the original Treasury Decision amending the Regulation with the exception of minor changes of detail.

[2] Upon audit of their income tax returns, the Commissioner of Internal Revenue required these Plaintiffs to include the raised breeding animals in their livestock inventory in each of such years.

nesses up to 1957, and the Commissioner of Internal Revenue has not consented for taxpayers to treat such purchased breeding animals as a capital asset in the years 1957, 1958 and 1959.

[fol. 12] (13) In each of the years here involved, as well as in the previous years, Plaintiffs culled and sold from their breeding herd some of their breeding animals (including both raised and purchased animals) which had been held and used by them for breeding purposes for more than twelve months before the date of such sales, but which were unfit for breeding purposes or which for other reasons were not suitable or desirable for retention in their breeding herds. Plaintiffs reported the gain on the sale of raised breeding animals as gain on the sale of capital assets and calculated such gain by using the accrued unit inventory value assigned to such animals as the basis. Also, in connection with their purchased breeding animals, Plaintiffs reported their gains on the sale of purchased breeding animals as gain on the sale of capital assets, and calculated such gain by using the cost thereof, less the depreciation claimed, as the basis for such animals sold.

(14) Plaintiffs' Federal income tax returns for each of the years here involved, which were timely filed and which reflected the foregoing, were audited by the Commissioner of Internal Revenue. In connection with such audit, Plaintiffs claimed in their protest filed with the Commissioner that Plaintiffs had erroneously included their raised breeding animals in inventory and had erroneously calculated gain on the sale of such raised breeding animals by using the accrued inventory value as the basis. Plaintiffs claimed that they were not required to include raised breeding animals in inventory and that they were not required to use the inventory value as the basis in computing gain on the sale of raised breeding animals, but should, instead, use a basis of zero in cal-

[fol. 13] culating the gain on the sale of raised breeding animals. Plaintiffs claims in this regard were based on the decision of the United States Court of Appeals, Fifth Circuit, in the case of *Scofield* v. *Lewis*, 251 F.2d 128, which declared that the Commissioner's Regulation re-

quiring taxpayers to include raised breeding animals in inventory were invalid. These claims were denied by the Commissioner. In addition, the Commissioner denied and disallowed the deduction claimed by Plaintiffs for depreciation with respect to purchased breeding animals. Furthermore, the Commissioner required Plaintiffs to include the breeding animals purchased in each of the years here involved in Plaintiffs' livestock inventories without any allowance for depreciation, exhaustion, wear and tear, and required Plaintiffs to use the inventory value (i.e., cost, without any allowance for depreciation) of purchased breeding animals as the basis for the calculation of gain upon the sale thereof.

(15) After paying the difference in tax claimed by the Commissioner, Plaintiffs filed timely claims for refund, based on removing raised breeding animals from closing inventory and capitalizing breeding animals purchased in 1957, 1958 and 1959, and reporting the gain on all breeding animals sold during the years in question as capital gains, using zero as the basis for raised breeding animals and using the depreciation cost as the basis for purchased breeding animals. In the computation of their claim for refund Plaintiffs also determined a reasonable allowance for depreciation on breeding animals purchased in 1957, 1958 and 1959 and deducted such in determining the amount of the refund. These claims [fol. 14] for refund were rejected, and these suits were filed in the United States District Court, Western District of Texas.

(16) In their claims for refund, in these suits, and in their motions for summary judgment, Plaintiffs claim, as to raised breeding animals, that the portion of Regulation 1.471-6, and its predecessors, by which Plaintiffs were required to include raised livestock held for breeding purposes in inventory, was and is invalid because it is in conflict with Section 1231 of the Internal Revenue Code which provides that livestock held for draft or breeding purposes constitute "property used in the trade or business" and that gains on the sale of "property used in the trade or business" shall be considered as gains from the sale of capital assets; since the raised breeding

animals were erroneously required to be included in inventory pursuant to the Regulation, Plaintiffs are entitled to remove such raised breeding animals from their closing inventory; and, properly computed, capital gain on the sale of raised livestock held for breeding purposes is the excess of proceeds from the sale over zero. As to purchased breeding animals, Plaintiffs claim that, since they did not elect to include breeding animals purchased in 1957, 1958 and 1959 in inventory, as permitted, but not required, by Regulation 1.471-6(f), they are entitled to a reasonable allowance for depreciation with respect to breeding animals purchased in 1957, 1958 and 1959 because such animals constitute property used in the trade or business, and are of a character subject to the allowance for depreciation provided in Section 167 of the Internal Revenue Code.

[fol. 15] (17) It is found as a fact that when Section 117(j) of the Internal Revenue Code of 1939, as amended by the Revenue Act of 1951, was re-enacted as Section 1231 of the Internal Revenue Code of 1954, Congress had no general or specific knowledge of the portion of the regulations in question requiring that taxpayers who used the unit-livestock-price method must include their raised breeding animals in inventory along with raised animals held for sale in the ordinary course of business.

(18) In view of the length and complexity of the Code itself, and the extreme length and complexity of the Regulations, it would be unreasonable to conclude that Congress had even a general knowledge of the full import of the Regulations. The letter of June 27, 1952, from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, which the Defendant describes as apprising Congress in most thorough and clear terms of the existing law as understood and administered regarding livestock held for breeding purposes, fails to mention or make reference to the fact that the Commissioner, by his Regulations, required taxpayers who used the unit-livestock-price method to include their raised breeding animals in inventory along with raised animals held for sale in the ordinary course of business. This letter did not constitute notice to Congress of the regulation in question.

(19) The Commissioner of Internal Revenue did not consider requests filed by ranchers to change their method of accounting for Federal income tax purposes from the accrual-inventory method to the cash receipts and disbursements method until the final regulations under [fol. 16] Section 481 of the Internal Revenue Code of 1954 were issued, same having been issued on February 19, 1959.

Conclusions of Law

(1) This Court has jurisdiction of these actions pursuant to the provisions of Section 1346(a)(1) of Title 28 United States Code, Act of July 25, 1948, C. 646, 62 Stat. 869, as amended by Act of July 30, 1954, C. 648, Sec. 1, 68 Stat. 589.

(2) Regulation 1.471.6(f), and specifically the portion thereof requiring the inclusion of breeding herd animals in a ranchman's inventory, is violative of, and is in conflict with, Section 1231 of the Internal Revenue Code and is, therefore, invalid; consequently, the Plaintiffs should not have been compelled to include their raised breeding herd animals in inventory. *Scofield* v. *Lewis*, 251 F.2d 128, affirming the decision of the United States District Court, Western District of Texas, 57-1 USTC, Paragraph 9251.

(3) Section 446(e) of the Internal Revenue Code, and the Regulations applicable thereto, requiring the consent of the Commissioner of Internal Revenue to any change in accounting method have no application to a situation where a taxpayer, within the three year statute of limitations after being charged with full knowledge of his right to correct the error in his inventory practices resulting from the invalid regulation referred to in the preceding paragraph, seeks to remove from inventory raised breeding animals which, under the statute, qualify as property used in the trade or business, and which were improperly required by such invalid reg- [fol. 17] ulation to be included in inventory in the first place. Inasmuch as this removal does not involve a change of accounting method, neither the approval nor the consent of the Commissioner is required. In this situation,

methods of accounting are not determinative of the tax liability, and for this reason neither approval nor consent of the Commissioner is required. See *Scofield* v. *Lewis*, supra, at page 132.

(4) Section 1231 of the Internal Revenue Code clearly and unequivocally states that livestock held for breeding purposes is property used in the trade or business of the taxpayer. As to such livestock, the taxpayers were not required to include them in an inventory, or to use a unit-livestock-price method to determine the cost basis of animals sold. *Scofield* v. *Lewis*, supra, at page 132.

(5) The so-called rule that re-enactment of a statute gives the force of law to a prior regulation interpreting the statute is not applicable in this case (a) because it has been found as a fact that Congress had no general or specific knowledge of the portion of the regulations in question [1], (b) because the portion of the regulations in question was not in fact a construction or interpretation of the statute but was an invalid provision in conflict with the statute, and (c) because the statute in question is clear and unequivocal and therefore the rule of re-enactment is not pertinent.[2]

[fol. 18] (6) Plaintiffs are entitled to remove from closing inventory, for each of the years involved, all raised breeding animals. As to raised breeding animals sold during the years in question, Plaintiffs shall compute capital gain on a basis of zero rather than inventory values.

(7) Plaintiffs' selection of the accrual (inventory) method of accounting and the unit-livestock-price method of valuing inventory when they commenced operating their ranches was not a meaningful choice, as the statute then did not authorize capital gains treatment in livestock used for draft, dairy or breeding purposes. It was not until 1951 that Congress authorized capital gains treatment on livestock by amending Section 117(j) of the

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[1] See *Mertens Law of Federal Income Taxation*, Vol. 1, Sec. 3.24, Pagges 49 and 51.

[2] See *Mertens*, supra, at page 48, where it is stated that "The doctrine (of statutory re-enactment) has no application where the law itself is plain and needs no administrative construction . . .".

1939 Code, and it was not until January 20, 1958, that the Court of Appeals for the Fifth Circuit decided the case of *Scofield* v. *Lewis*, supra. Thus, in any event, the first time that Plaintiffs could have had the kind of full and complete knowledge necessary to an enlightened and meaningful free choice as to their right to correct the error in their inventory practices resulting from the invalid regulation referred to in paragraph (2) of these conclusions of law, would have been with respect to the taxable year 1957. Plaintiffs, since filing their 1957 tax return have validly made their election as to 1957, and it was timely accomplished within the period allowed them by the three year statute of limitations in the tax laws.

(8) Since Plaintiffs B. E. WILSON, R. W. HODGE and F. J. BARRETT did not include their raised breeding animals in their inventories in the year 1957, 1958 and 1959, they clearly made a valid election with respect to [fol. 19] the taxable year 1957, as to the accounting method they desired to use, and any subsequent change therein would have required the consent of the Commissioner.

(9) The holding of the Court of Appeals for the Fifth Circuit in *Scofield* v. *Lewis*, supra, that the Treasury Regulation in question is invalid as to raised breeding animals, is controlling as to the raised breeding animals involved in this case.

(10) Having for each year, from the inception of their businesses up to 1957, voluntarily elected to include purchased breeding animals in inventory, without having been required by the Treasury Regulations to do so, the taxpayers are bound by that election for 1957, 1958 and 1959, as well as for future years, with respect to all purchased breeding animals, unless they obtain the Commissioner's consent to change. Revenue Ruling 60-60, 1960-1, Cum. Bull 190; Cf. *Carter* v. *Commissioner*, 257 F.2d 595, (5 Cir. 1958).

(11) Plaintiffs' Motions for Summary Judgment with respect to raised animals held for breeding purposes should be granted, but insofar as they relate to purchased animals held for breeding purposes they should be denied.

(12) Defendant's Motions for Partial Summary Judgment with respect to raised animals held for breeding purposes should be denied, but insofar as they relate to purchased animals held for breeding purposes they should be granted.

[fol. 20] (13) Judgment will be entered in accordance with these findings of fact and conclusions of law.

Dated at San Antonio, Texas, this 30th day of September, 1963.

/s/ ADRIAN A. SPEARS
/s/ ADRIAN A. SPEARS
United States District Judge

* * * *

[fols. 21-64] * * *

[fol. 65]

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
DEL RIO DIVISION

CIVIL ACTION
No. 307

W. H. WARDLAW and wife, MATTYE GWEN WARDLAW,
PLAINTIFFS

vs.

UNITED STATES OF AMERICA, DEFENDANT

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between Plaintiffs and Defendant, by their respective attorneys of record, that the following facts may be taken as true without the necessity of either party hereto introducing evidence in support thereof other than this Stipulation, but this shall not prevent either party hereto from introducing upon the trial of this case such further evidence not inconsistent with the facts herein stipulated to be true as such party see fit:

1. Plaintiffs W. H. WARDLAW and MATTYE GWEN WARDLAW are husband and wife and are citizens of the State of Texas and at all material times herein resided in Val Verde County, Texas, and are legal residents within the Western District of Texas, Del Rio Division of the United States District Court.

W. H. WARDLAW was at all material times herein a partner in Wardlaw Brothers, a copartnership composed of C. W. WARDLAW, W. H. WARDLAW and C. W. WARDLAW and W. H. WARDLAW as Trustees under the Will of CODY M. WARDLAW, Deceased, [fol. 66] said partnership being herein after referred to as the "Partnership."

2. The Partnership made, executed and duly filed within the time prescribed by law with the District Director of Internal Revenue for the First District of Texas, its

partnership income tax returns for the calendar years 1955, 1956, 1957, 1958 and 1959, respectively, copies of each of which are attached hereto marked Exhibits "A", "B", "C", "D" and "E". Plaintiffs made, executed and duly filed within the time prescribed by law with the District Director of Internal Revenue for the First District of Texas, in which District Plaintiffs resided, joint income tax returns for the calendar years 1955, 1956, 1957, 1958 and 1959, respectively, copies of each of which returns are attached hereto, marked Exhibits "F", "G", "H", "I" and "J", respectively. Plaintiffs paid the tax respectively disclosed in such returns to the District Director of Internal Revenue for the First District of Texas within the time prescribed by law.

3. The Partnership and Plaintiffs as copartners thereof. have been engaged in the business of ranching in Val Verde County, Texas, as co-partners since 1935, and were so engaged during the years 1955 through 1959, such ranching business being conducted on certain land situated in Val Verde County and Edwards County, Texas, which Plaintiffs own or lease.

4. Since 1935 and at all material times herein, the ranching business conducted by the Partnership consisted of breeding and raising sheep, goats and cattle, principally for the production of wool, mohair, mutton and calves. The Partnership maintained breeding herds of [fol. 67] sheep, goats and cattle for use in connection with their ranching business. As circumstances required, the Partnership purchased bucks, ewes, billies, nannies, bulls and cows for addition to their breeding herd to increase their herds, improve the quality and prevent inbreeding. Also, as circumstances required, the Partnership selected certain lambs, kids and calves produced from the breeding herd and added same to the breeding herd. The number of animals to be retained in the breeding herds were determined on the basis of range conditions, rainfall, cost of operation and other factors. When required by age, disease or other circumstances, the Partnership culled from their breeding herd animals which were sold for breeding purposes but which were unfit for breeding stock or which for some other reason could not be retained

and same were sold. Lambs, kid and calves produced by the breeding herd and not added to the breeding herd were sold in the due course of business.

5. When the Partnership commenced its ranching business in 1935, Plaintiffs selected the inventory (accrual) method of accounting. From 1935 until the effective date of Regulation 111, Sec. 29.22(c)-6, as amended by TD 5423, December 15, 1944, 1945 CB-70, Plaintiffs carried all of their livestock on an inventory basis, and valued such livestock inventories under the constant price method. In each year, from the effective date of Regulation 111, Sec. 29.22(c)-6, as amended by TD 5423, supra, (i.e., including and after the taxable year 1944 and thereafter) and at all material times thereafter, the Partnership was required by the Regulations next below mentioned to and did carry all their livestock raised and held for sale on the market, and also their raised and [fol. 68] purchased livestock[1] constituting their breeding herd and held by them for breeding purposes, on an inventory basis valuing all purchased livestock at cost, and all raised livestock under the unit livestock price method pursuant to and in accordance with Treasury Regulation 111, Sec. 29.22(c)-6 as amended by TD 5423, 1945 CB-70, and its successor, Regulation 118, Sec. 39.22(c)-6, and Regulation 1.471-6, as applicable, same being hereinafter referred to as "the Regulations."

6. As the first step in determining their "Net Profit" from their ranching business for income tax purposes in their income tax returns for 1955, 1956, 1957, 1858 and 1959, the Partnership deducted from their "Gross Sales" of livestock and livestock products the "Cost of (such) Goods Sold" to arrive at their "Gross Profit."

7. In determining their "Costs of Goods Sold" with respect to their ranching business, (as a part of the determination of Gross Profit), the Partnership determined

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[1] The Partnership did not include breeding herd animals purchased in 1957, 1958 and 1959 in the inventories of livestock as reported in their income tax returns; however, the Commissioner of Internal Revenue, upon audit of the Partnership income tax returns for 1957, 1958 and 1959 required that all such animals be included in the Partnership closing inventory for such years, as more fully appears in Paragraph 26, below.

their inventory of livestock at the beginning of the year, (herein referred to as the "Opening Inventory") valued same in compliance with the unit livestock price method, as provided in the Regulations, added thereto all animals purchased and subtracted therefrom their inventory of livestock at the end of the year (herein referred to as the "Closing Inventory") valued in compliance with the [fol. 69] unit livestock price method as provided in the Regulations, to arrive at their "Cost Of Goods Sold."

8. As the second step in determining their "Net Profit" from their ranching business for income tax purposes in their income tax returns for 1955, 1956, 1957, 1958 and 1959, the Partnership deducted from their "Gross Profit" for such year depreciation sustained with respect to property used in their trade or business and cost of labor, materials and supplies, and all other expense incurred in their trade or business to arrive at their "Net Profit" for income tax purposes.

9. The calculations described in Paragraphs 6, 7 and 8 above are summarized in columnar form as follows:

Gross Sales of Livestock and Livestock Products		00.00
(less)		
Cost of Goods Sold		
Opening Inventory	00.00	
add: Purchased Animals	00.00	
Total	00.00	
less: Closing Inventory	00.00	00.00
(equals)		
Gross Profit		00.00
Less: Depreciation	00.00	
Labor	00.00	
Materials & Supplies	00.00	00.00
Expenses	00.00	00.00
(equals)		
Net Profit		00.00

9a In applying the steps set out in Paragraph 9 above to determine "Net Profit" in this case, proceeds from the [fol. 70] sale of breeding animals were not included in "Gross Sales" and "Opening Inventory" was reduced in the year of sale of such breeding animals, by the amount of inventory value of breeding animals sold.

10. Attached hereto marked Exhibits "K", "L", "M", "N" and "O" are schedules of livestock owned by the Partnership as of December 31, 1957, 1958 and 1959, respectively, showing the following according to kind and classification thereof.

Column I: Unit livestock prices with respect to each kind and classification of livestock.

Column II: Inventory of livestock (and the unit values assigned thereto as shown in Column III) as reported by Plaintiffs in their Federal Income tax returns.

Column IV: Number of head of livestock (and the values thereof as shown in Column V) constituting the breeding herd of Plaintiffs which had been raised or purchased by them in years prior to 1955, 1956, 1957, 1958 and 1959, respectively.

Column VI: Number of head of livestock (and the values thereof as shown in Column VII) purchased by Plaintiffs and added to their breeding herd during 1955, 1956, 1957, 1958 and 1959, respectively.

Column VIII: Number of head of livestock (and the values thereof as shown in Column IX) raised by Plaintiffs and added to their

[fol. 71]

breeding herd during 1955, 1956, 1957, 1958 and 1959, respectively.

Column X: Number of head of livestock (and the values thereof as shown in Column XI) held by Plaintiffs for sale on the market.

11. In connection with the valuation of their inventory of livestock, Plaintiffs assigned to the various kinds, classifications and categories of raised animals [2] included

[2] Upon audit of the Partnership income tax for 1957, 1958 and 1959, the Commissioner of Internal Revenue required that purchased breeding animals be also included in the closing inventory for such years.

within such inventory, a unit value in accordance with the Regulations as described in Column I of Exhibits "K", "L", "M", "N" and "O" attached hereto, and as such livestock advanced in age, there was assigned to and accrued with respect to such raised livestock the respective unit values and respective advances in accordance with said Regulations.

12. The livestock described in Column X of Exhibits "K", "L", "M", "N" and "O", respectively, constituted the livestock raised and held by the Partnership for sale on the market as of December 31, 1955, 1956, 1957, 1958 and 1959, respectively.

13. The livestock described in Columns IV, VI and VIII of Exhibits "K", "L", "M", "N" and "O" attached hereto constituted the breeding herd of the Partnership and was held and used by the Partnership for breeding purposes in conducting their trade or business during 1955, 1956, 1957, 1958 and 1959, respectively, said breeding herd being comprised in the aggregate of the livestock [fol. 72] described in Column IV which had been raised or purchased by the Partnership and was held by them for breeding purposes in 1955, 1956, 1957, 1958 and 1959, respectively, and the livestock described in Column VI which was purchased by the Partnership and added to their breeding herd and held by the Partnership for breeding purposes during 1955, 1956, 1957, 1958 and 1959, respectively, and the livestock described in Column VIII, which was raised by the partnership and added to their breeding herd and held by the Partnership for breeding purposes in 1955, 1956, 1957, 1958 and 1959, respectively.

14. The livestock referred to in Paragraph 13 next above constituted "property used in the trade or business" of the Partnership as defined in Section 1231 of the Internal Revenue Code of 1954, provided that such livestock met the requisite holding period.

15. In their Partnership income tax returns for 1955, 1956, 1957, 1958 and 1959, respectively, the Partnership carried all of their livestock raised and held for sale on the market, and also their raised animals constituting their breeding herd and held and used by them for breeding purposes, on an inventory basis, as described in

Column II of Exhibits "K", "L", "M", "N" and "O", respectively, valuing such livestock inventories under the unit livestock price method as described in Column III of Exhibits "K", "L", "M", "N" and "O", respectively, in accordance with the Regulations.

(c) Each increase in the closing inventory decreased the "Cost of Goods Sold" and concurrently increased "Gross Profit" and "Net Profit."

[fol. 73] 18. During 1957, 1958 and 1959, respectively, the Partnership purchased the livestock described in Column VI of Exhibits "M", "N" and "O", respectively, for addition to their breeding herd to increase their herds and improve the quality thereof.

19. Such livestock referred to in Paragraph 18 above constituted "property used in the trade or business" of the Partnership, as defined in Section 1231 of the Internal Revenue Code, and was of a character which was subject to the allowance for depreciation provided for in Section 167 of the Internal Revenue Code, provided such livestock met the requisite holding period of Sec. 1231.

20. In their income tax returns for 1957, 1958 and 1959, the Partnership treated such animals referred to in Paragraph 18 above as property used in their trade or business, subject to depreciation and computed and deducted, in determining their net profit from their ranching business, a reasonable allowance for depreciation sustained in such years, respectively, with respect to such livestock.

21. During 1955, 1956, 1957, 1958 and 1959, respectively, the Partnership culled and sold from their breeding herd some of their sheep, goats and cattle, (including both raised and purchased animals) which had been held and used by them for breeding purposes for more than twelve months before the date of such sales but which were unfit for breeding purposes or which for other reasons were not suitable or desirable for retention in their breeding herds.

[fol. 74] 22. Such raised livestock referred to in Paragraph 21 was included in the Partnership's inventory of livestock in 1955, 1956, 1957, 1958 and 1959, respectively, and in years prior thereto, subsequent to the effective

date of the Regulations, and in such years, pursuant to the requirements of the Regulations, unit values had been assigned to such livestock as and when same were included in such inventory and the respective advances accrued with respect to such livestock as same advanced in age and classification, all in accordance with the unit livestock price method as provided in the Regulations.

23. In their income tax returns for 1957, 1958 and 1959, the Partnership, pursuant to the provisions of Section 1231 of the Internal Revenue Code, reported their gains on the sale of purchased livestock held for breeding purposes as gains on the sale of capital assets. The Partnership calculated such gains by using as the basis for such animals sold the cost thereof, less the depreciation claimed with respect thereto.

24. In their income tax returns for 1955, 1956, 1957, 1958 and 1959, the Partnership, pursuant to the provisions of Section 1231 of the Internal Revenue Code, reported their gains on the sale of raised livestock held for breeding purposes as gains on the sale of capital assets. The Partnership calculated such gains by using as the basis of such animals sold the accrued unit values assigned to such animals in the Partnership's inventory of livestock. In connection with the use of the accrued unit value assigned to such animals in the Partnership's inventory as the basis, the Partnership made an adjustment to their opening inventory to eliminate therefrom in [fol. 75] the year of such sale, the accrued unit value of such livestock sold.

25. For each of the years 1955, 1956, 1957, 1958 and 1959, as a result of the use of the accrued unit values assigned to livestock raised and held by the Partnership for breeding purposes in their livestock inventory as the basis for calculation of gain upon the sale thereof, amounts equal to the proceeds of such sales were

(a) Subjected to tax, in the year of such sale, at the rates applicable to gains on sale of long term capital assets, to the extent of the difference between the proceeds of such sale and the accrued unit value assigned to such livestock in the opening inventory in the year of sale, and

(b) Subjected to tax, in the year or years prior to such year of sale, at the rates applicable to ordinary income to the extent of the accrued unit values and advances thereof assigned to such livestock in closing inventory in such prior year or years.

26. Thereafter, the Commissioner of Internal Revenue caused the Partnership's income tax returns for 1955, 1956, 1957, 1958 and 1959 to be audited. In connection with such audits, the Partnership claimed, and so advised the Commissioner of Internal Revenue, in their Protest filed with him, that the Partnership had erroneously included their raised breeding animals in their livestock inventory, and further, that the Partnership had erroneously calculated their gains on the sale of raised breeding animals by using as the basis therefor the accrued unit values assigned to such animals in the Partnership's inventory, stating in said Protest as the reasons wherein [fol. 76] such was erroneous the same reasons subsequently stated in their claims for refund, hereinafter referred to, all of which claims of the Partnership were denied by the Commissioner. In addition thereto, the Commissioner denied and disallowed the deduction claimed in the Partnership's income tax returns for depreciation with respect to purchased animals held for breeding purposes, and the Commissioner adjusted Plaintiffs' livestock inventory to include such purchased breeding animals in Plaintiffs' inventories of livestock. As a result of such audits, the Commissioner of Internal Revenue determined a deficiency in income taxes due from Plaintiffs for each of said years, which deficiency was in part attributable to matters not presently in controversy and was in part attributable to the matters in controversy in this proceeding relating to the determination of the Partnership's inventories of livestock, and the calculation of gains upon the sale of livestock held by the Partnership for breeding purposes, and which deficiency including statutory interest thereon, was by Plaintiffs paid to the District Director of Internal Revenue for the First Collection District of Texas at Austin, Texas, within the time and in the manner required by law.

27. Thereafter, within the period within which claims for refund might be legally filed under Section 6511 of

the Internal Revenue Code, Plaintiffs presented and delivered to Robert L. Phinney, as District Director of Internal Revenue for the First District of Texas, at Austin, Texas, for transmission to the Commissioner of Internal Revenue, their claims for refund for overpayment of income taxes assessed against and paid by Plaintiffs for 1955, 1956, 1957, 1958 and 1959, copies of each of which [fol. 77] claims for refund being attached hereto marked Exhibits "P", "Q", "R", "S" and "T". Attached to each of said Claims for Refund for 1957, 1958 and 1959 is a schedule showing:

Column I: Computation of Partnership's net profits from their ranching business and Plaintiffs' taxable income and tax as reflected in Plaintiffs, income tax return for such year as reported by Plaintiffs.

Column II: Adjustments to Partnership's net profits from their ranching business and Plaintiff's taxable income as reported, made by the Commissioner of Internal Revenue acting by and through his Field Agent, upon audit of Plaintiffs' income tax return for such year.

Column III: Computation of Partnership's net profits from their ranching business and Plaintiffs' taxable income and tax as adjusted and finally determined by the Commissioner of Internal Revenue after audit.

Column IV: Adjustments and corrections to Partnership's net profits from their ranching business and Plaintiffs' taxable income and tax as determined by the Commissioner of Internal Revenue as claimed by Plaintiffs in asserting their Claim for Refund with respect to such year.

Column V: Computation of Plaintiffs' taxable income and tax as claimed by Plaintiffs in their Claim for Refund for such year.

[fol. 78] Each of such schedules attached to said Claim for Refund are incorporated herein as Exhibits "R-1", "S-1" and "T-1".

28. Said Claims for Refund filed by Plaintiffs for 1955, 1956, 1957, 1958 and 1959 were based in part on the following grounds:

(A) That raised and purchased livestock held for breeding purposes was erroneously included in their closing inventories of livestock for 1955, 1956, 1957, 1958 and 1959, respectively, and that such was erroneous for the following reasons, as set forth in the Claims for Refund.

(1) Said livestock was raised or purchased and held by the Partnership for breeding purposes and as such was used by the Partnership in conducting their trade or business;

(2) Such raised or purchased livestock so held was "property used in a trade or business of a character which is subject to the allowance for depreciation" within the meaning and intent of Sec. 1231 of the Internal Revenue Code of 1954;

(3) The term "property used in a trade or business" within the meaning and intent of Section 1231 of the Internal Revenue Code of 1954 excludes property of a kind which would be properly includible in inventory;

(4) Raised or purchased breeding animals held by the Partnership for breeding purposes are not property of a kind which would be properly includible in inventory;

[fol. 79] (5) The Partnership was not and is not required to include raised or purchased livestock held for breeding purposes in inventory;

(6) That portion of said Regulations which require the Partnership to include raised or purchased livestock held for breeding purposes in inventory were and are invalid and of no force and effect.

(7) The United States Court of Appeals, Fifth Circuit, in the case of Scofield vs. Lewis, 251 F(2) 128, affirming a decision of the United States District Court, Western Division of Texas, San Antonio Division, rendered in Civil Action No. 1998, styled A. J. Lewis, et al.,

vs. Scofield, has held that a taxpayer is not required to include livestock held for breeding purposes in inventory.

(B) That the Partnership was entitled to treat livestock purchased and held for draft, dairy or breeding purposes as capital assets subject to depreciation and the Partnership was entitled to deduct a reasonable allowance for depreciation on purchased animals held for draft, dairy or breeding purposes.

(C) That the calculation of gain upon the sale during 1955, 1956, 1957, 1958 and 1959 of raised breeding animals by using as a basis for such animals sold the accrued unit values assigned to such animals in the Partnership's inventory of livestock was erroneous in that:

(1) Such raised livestock held for breeding purposes was erroneously included in Partnership's inventory of livestock in the first instance, and consequently, the accrued unit values with respect to such animals should not have been assigned to or accrued with respect to such animals as the basis therefor.

[fol. 80] (2) Such livestock, having been raised by the Partnership, had no cost basis and for purposes of calculating the gains derived upon the sale thereof, the Partnership should have used, and was required to use, a zero basis for such animals.

(D) That the calculation of gain upon the sale during 1957, 1958 and 1959 of purchased breeding animals which were included in the Partnership's inventory of livestock by the Commissioner of Internal Revenue by using as the basis for such animals sold the unit values assigned to such animals in the Partnership's inventory of livestock was erroneous in that:

(1) Such purchased livestock held for breeding purposes was erroneously included in the Partnership's inventory of livestock in the first instance and consequently, the accrued unit values with respect to such animals should not have been assigned to or accrued with respect to such animals as the basis therefor;

(2) Such livestock, having been purchased by Partnership had a basis equal to their cost and for purposes of calculating the gains derived from the sale thereof,

the Partnership should have used and was required to use the cost of such animals, less the depreciation taken with respect thereto, as the basis for such animals.

29. The Commissioner of Internal Revenue denied and disallowed the Partnership's Claim for Refund for 1955, and 1956 on February 17, 1960, and denied and disallowed Plaintiffs' Claim for Refund for 1957, 1958 and 1959 on July 17, 1962.

30. The Partnership has not at any time filed a request for a change in their accounting method with the [fol. 81] Commissioner of Internal Revenue, and the Commissioner has given no consent to a change in Plaintiffs' accounting method.

31. It was the policy of the Commissioner of Internal Revenue not to consider requests filed by ranchers to change their method of accounting for Federal income tax purposes from the accrual (inventory) method to the cash receipts and disbursements method until the final Regulations under Sec. 481 of the Internal Revenue Code of 1954 were issued.

32. The Partnership has taken ordinary deductions for the cost of raising and maintaining raised livestock. The Partnership has taken ordinary deduction for the cost of maintaining purchased livestock.

/s/ ELWOOD CLUCK
Attorney for Plaintiffs

/s/ JOHN A. BAILEY
Attorney for Defendant

[fols. 82-114] * * *

Exhibit R to Stipulation of Facts

FORM 843 (Rev. Mar. 1960)

U. S. TREAS DEPARTMENT - INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

District Director's Stamp (Date received)

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- [x] Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- [ ] Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- [ ] Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps

W. H. and MATTYE G. WARDLAW

Number and street: Box 1118

City, town, postal zone, State: Del Rio, Texas

Fill in applicable items—Attach letter size sheets if space is not sufficient

1. Social security number:

2. If an employer, enter employer identification number:

3. District in which return (if any) was filed: 1st District of Texas, Austin, Texas

4. Name and address shown on return, if different from above: Same

5. Period—if for tax reported on annual basis, prepare separate form for each taxable year: From January 1, 19 57 To December 31, 19 57

6. Kind of tax: Income

7. Amount of assessment: $ 6,760.37

Dates of payment:

8. Date stamps were purchased from Government:

9. Amount to be refunded: $ 6,760.37*

10. Amount to be abated (not applicable to income, estate, or gift taxes): $

11. The claimant believes that this claim should be allowed for the following reasons:

*Or such greater or lesser amount as may be legally refundable, plus interest.

See statement attached.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed W. H. WARDLAW

Dated April 30, 19 62 MATTYE G. WARDLAW

INSTRUCTIONS

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, enter social security and employer identification number, if any, of both husband and wife and each must sign this claim even though only one had income.

3. Whenever it is necessary to have the claim executed by an agent on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent to sign the claim on behalf of the taxpayer shall accompany the claim.

4. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

6. If claim is for excess social security (F.I.C.A.) tax withheld as a result of having had more than one employer, include the names and addresses of your employers, and the amount of wages received and taxes withheld by each as part of your explanation in item 11. Do not claim tax withheld if you have claimed the excess withholding on your individual income tax return.

Exhibit R 435

FORM 843 (Rev. 3-60)

[fol. 115]

[fol. 116]

LIVESTOCK INVENTORY AND RELATED MATTERS:

The Taxpayer is a partner in the partnership of Wardlaw Brothers, which conducts a ranching business consisting of breeding and raising sheep, goats, cattle and horses, principally for the production of wool, mohair, mutton, calves and colts. During the taxable year 1957, the partnership carried its livestock held for sale on an inventory basis and valued such livestock under the unit livestock price method, but did not include within such inventory the livestock constituting the breeding herds and held for breeding purposes. Upon audit of the partnership return for said year, the field agent required the partnership to include in its livestock inventory the raised, and also the purchased, livestock held for breeding purposes and to value same in accordance with the unit livestock price method, and further required the partnership to assign as cost basis for the purpose of computing gain on the sale of such raised breeding animals, the accrued unit value thereof as reflected in such inventory, such being erroneous in that:

(a) Livestock raised and held by the partnership for breeding purposes constituted property used in its trade or business within the meaning of Section 1231, I.R.C.

(b) Property used in a trade or business is not property of a kind which would be properly includible in inventory.

(c) The provisions of Regulation 39.22(c)-6 (2)(f) as amended by TD 5423, 1945, CB-70, are contradictory to the provisions of Section 1231, I.R.C. and are invalid. Scofield vs. Lewis, 251 F(2) 128.

[fol. 117] (d) Livestock purchased for draft, dairy or breeding purposes had a basis equal to its cost and for purpose of calculating gain on the sale thereof, the partnership is required to use as its basis the depreciated cost of such animals. Raised livestock held for draft, dairy or breeding purposes had no cost basis and, for purposes of calculating gain on the sale thereof, the partnership is required to use a zero basis for such animals.

(e) The partnership was not and is not required to use as the basis the accrued unit values thereof as reflected in such inventory in computing gain on the sale of raised or purchased breeding animals.

The partnership was entitled to elect, and did elect, to treat livestock purchased and held for draft, dairy or breeding purposes as capital assets subject to depreciation; and the partnership is entitled to deduct a reasonable allowance for depreciation on purchased animals held for draft, breeding or dairy purposes.

The partnership claimed depreciation on certain improvements, equipment, automobiles and trucks. Upon audit of the return, the Field Agent disallowed depreciation thereon in the aggregate amount of $3,049.16, upon the ground that such was excessive, which was erroneous in that the partnership correctly computed, claimed and was entitled to deduct depreciation upon such improvements, equipment, automobiles and trucks, as set forth in said return.

GUARANTY FUND DEDUCTION:

On June 19, 1957, the Del Rio National Bank closed by order of the Comptroller of Currency, as a result of [fol. 118] shortages and other discrepancies and its affairs were placed in the hands of the FDIC for liquidation. The partners of said partnership believed that the closing of the Bank would precipitate a financial crash with severe detrimental effects upon the partnership's ranching business. In order to protect and preserve its ranching business, the partnership, during the period June 19, 1957 and July 2, 1957, joined with other persons to rehabilitate the Bank under a plan approved by the Comptroller of Currency whereby a Guaranty Fund was created, cash contributions thereto were provided for and the funds thus obtained were used to acquire assets deemed objectionable by the Comptroller of Currency from the Bank in order that the Bank could be rehabilitated. The Guaranty Fund was to be administered by Trustees for a period of two years, and upon termination on June 19, 1959, the contributions to the Guaranty Fund, less the losses sustained during such period, were to be re-

turned to the contributors. The partnership contributed $122,975.00 to the Guaranty Fund. On July 3, 1957, the plan of rehabilitation was consummated and the Bank was reopened.

At the close of 1957, it was determined that the contributors to the Guaranty Fund, including the partnership, had sustained a net loss of $57.82% of their contributions to the Guaranty Fund and the partnership deducted such proportion of its contribution in its income tax return for 1957. Upon audit of its return, the Field Agent disallowed the deduction, which action was subsequently affirmed upon review.

The partnership is entitled to deduct in full the total amount of $122,975.00 contributed to the Guaranty Fund [fol. 119] in 1957 in that such expenditure was made by the partnership for the purpose of promoting or protecting its business and same constitutes an ordinary and necessary expense paid during the taxable year in carrying on its trade or business within the meaning of I.R.C., Sec. 162(a), or in the alternative, that it is entitled to deduct the net loss sustained in 1957 in the amount of 57.82% of its contribution to the Guaranty Fund, upon the grounds that same constitutes a loss not compensated by insurance or otherwise within the meaning of I.R.C., Sec. 165(a).

By reason of the erroneous treatment of said livestock and the erroneous disallowance of such depreciation in calculating the partnership income, all as is more particularly hereinabove set forth, Taxpayer's income was erroneously calculated in his individual income tax return and Taxpayer is, therefore, entitled to refund as hereinabove and hereinbelow stated.

There is attached hereto Schedule and computations for Taxpayer and said partnership, to which reference is here made for all purposes, showing the following:

Column 1. Computation of partnership income and Taxpayer's taxable income and tax as reflected in the partnership and Taxpayer's income tax returns as filed.

Column 2. Adjustments made thereto by the field agent upon audit.

Column 3. Partnership income and Taxpayer's taxable income and tax as adjusted by field agent upon audit.

[fol. 120]

Column 4. Adjustments claimed by Taxpayer in the claim for refund.

Column 5. Partnership income and Taxpayer's taxable income and tax as claimed in this claim for refund.

Said Schedule and computations attached hereto are incorporated herein and made a part of this Claim for Refund.

Addenda to Claim for Refund in re Livestock Inventories:

Taxpayer is entitled to recast the livestock inventory for the year covered by this Claim for Refund and for the years prior thereto, which are open and subject to adjustment, and for all years subsequent thereto, and to remove from both the opening and closing inventories all raised livestock held for breeding purposes and erroneously included therein. In connection with the opening inventory of the earliest year which is open and subject to adjustment (including the year covered by this Claim for Refund, if it be the earliest year open and subject to adjustment), Taxpayer is entitled to a deduction against ordinary income in an amount equal to the accrued unit values of all raised livestock held for breeding purposes therefore erroneously included in such inventory, or, in the alternative, Taxpayer is entitled to amortize an amount equal to the accrued unit values of all raised livestock held for breeding purposes theretofore erroneously included in such inventory, over a period not in excess of five years.

W. H. and Mattye C. Wardlaw (2)

Taxable income and tax
Year ended December 31, 1957

W. P. No.	57-1
ACCOUNTANT	HW
DATE	12/2/58

	Per Return	Difference	Per R.A.R.	Difference	Per claim
Income:					
Director fees, Del Rio National Bank	600 00	-	600 00	-	600 00
Dividends	609 95	⟨306 90⟩	303 05	-	303 05
Interest	275 00	1154 87	1429 87	-	1429 87
Capital gains or ⟨losses⟩	4906 15	⟨5211 73⟩	4284 42	5116 09	9400 51
Rents and royalties	14 21	-	14 21	-	14 21
Estates and trusts:					
C. W. Pritchard	264 35	-			
C. G. Wardlaw	249 51	-			
	501 245	⟨309 48⟩	4703 17		4703 17
Partnerships:					
Wardlaw Brothers	⟨31644 22⟩	16956 97	14312 75	⟨40512 85⟩	⟨26200 10⟩
Jennings ranch	1101 58	-	1101 58		1101 58
Other sources	232 52	-	232 52		232 52
Adjusted gross income	⟨18992 16⟩	25915 73	26981 57	⟨35396 76⟩	⟨8415 19⟩
Deductions and exemptions:					
Standard or itemized deduction	- 0 -	⟨1000 00⟩	⟨1000 00⟩	1000 00	- 0 -
Personal exemptions	- 0 -	⟨2400 00⟩	⟨2400 00⟩	2400 00	- 0 -
Taxable income	⟨18992 16⟩	22515 73	23581 57	⟨31996 76⟩	⟨8415 19⟩
Taxes:					
Income tax	- 0 -	664 00	664 00	⟨664 00⟩	- 0 -
Self employment tax	- 0 -	141 75	141 75	⟨141 75⟩	- 0 -
Dividends received credit	- 0 -	⟨22 38⟩	⟨22 38⟩	⟨22 38⟩	- 0 -
Balance of tax	- 0 -	676 37	676 37	⟨676 37⟩	- 0 -

Wardlaw Brothers, A Partnership (TP)
Taxable Income
Year ended December 31, 1957

W. P. No.	57-1
ACCOUNTANT	[illegible]
DATE	9/21/61

	Per Return	Difference	Per R.A.R.	Difference	Per Claim	
Profit or (loss) from business:						
Sales	23277660	1225 00	23106160	–	23106160	
Less cost of goods sold:						
Inventory at beginning of year	20653700	1266285	21919985	(1366385)	3469600	
Purchases	24000		24000	–	24000	
	20677700	1266285	21943985	(1366385)	3493600	
Less inventory at end of year	20387615	529429	21651044	(1956924)	6105120	57-3
Cost of goods sold	290085	(1030144)	(37010659)	1179539	(2621520)	
Gross profit	22742575	1167644	21690219	(1179539)	25727610	
Deductions:						
Depreciation - furniture	113164	(113164)	–	127399	127399	57-2
Death losses - building bond	–			1010161	1010161	57-5
Guaranty fund	71104 15	(71104 15)	–	71104 15	71104 15	
Other deductions	2487572	(101020)	2456552	–	2456552	
Total deductions	2791 00 51	(7331599)	2456852	8948675	33517227	
Net profit or (loss)	(915057)	1148992	233167	(1012814)	(779647)	
Other income:						
Interest	306509	–	306509		306509	
Rents and royalties	93012	–	93012		93012	
Ordinary income or (loss)	(791105)	1148992	357887	(1012814)	(655026)	
Partners share of ordinary income:						
Walter H. Wardlaw 40%	(316442)	459597	143155	(405126)	(262010)	
Crawford W. Wardlaw 40%	(316442)	459597	143155	(405126)	(262010)	
Trust #1, for Cody H. Wardlaw Jr. 10%	(79111)	114899	35788	(101282)	(65503)	
Trust #1, for Tennille Wardlaw 10%	(79111)	114899	35788	(101282)	(65503)	
	(791105)	1148992	357887	(1012814)	(655026)	
Capital gains	24162 01	(25672)	21589 76	2558044	4717520	57-4
Partners share of capital gains						
Walter H. Wardlaw 40%	9664 10	(10269)	8637 90	10232 18	18870 08	
Crawford W. Wardlaw 40%	9664 81	(10269)	8637 90	10232 18	18870 08	
Trust #1, for Cody H. Wardlaw Jr. 10%	2416 20	(2567)	2159 78	2558 04	4717 52	
Trust #1, for Tennille Wardlaw 10%	2416 20	(2567)	2159 78	2558 04	4717 52	
	24162 01	(25672)	21589 76	25580 44	47175 20	

Ex. No. 1 to Stip. of Facts

Exhibit 2 to Stipulation of Facts

FORM 843 (Rev. Mar. 1960)

U. S. TREA' DEPARTMENT - INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

District Director's Stamp (Date received)

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- [X] Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- [ ] Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- [ ] Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
W. H. and MATTYE G. WARDLAW

Number and street
Box 1118

City, town, postal zone, State
Del Rio, Texas

Fill in applicable items—Attach letter size sheets if space is not sufficient

1. Social security number

2. If an employer, enter employer identification number

3. District in which return (if any) was filed
1st District of Texas
Austin, Texas

4. Name and address shown on return, if different from above
Same

5. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 1958 To December 31, 1958

6. Kind of tax
Income

7. Amount of assessment
$ 26,574.16

Dates of payment

8. Date stamps were purchased from Government

9. Amount to be refunded
$ 15,753.36*

10. Amount to be abated (not applicable to income, estate, or gift taxes)
$

11. The claimant believes that this claim should be allowed for the following reasons:

*Or such greater or lesser amount as may be legally refundable, plus interest.

See statement attached.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed W. H. WARDLAW

Dated April 30, 1962 MATTYE G. WARDLAW

INSTRUCTIONS

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, enter social security and employer identification number, if any, of both husband and wife and each must sign this claim even though only one had income.

3. Whenever it is necessary to have the claim executed by an agent on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent to sign the claim on behalf of the taxpayer shall accompany the claim.

4. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

6. If claim is for excess social security (F.I.C.A.) tax withheld as a result of having had more than one employer, include the names and addresses of your employers, and the amount of wages received and taxes withheld by each as part of your explanation in item 11. Do not claim tax withheld if you have claimed the excess withholding on your individual income tax return.

FORM 843 (Rev. 3-60)

Exhibit 5 341

[fol. 128]

[fol.124] Taxpayer is a partner in the partnership of Wardlaw Brothers, which conducts a ranching business consisting of breeding and raising sheep, goats, cattle and horses, principally for the production of wool, mohair, mutton, calves and colts.

During the taxable year 1957, the partnership carried its livestock held for sale on an inventory basis and valued such livestock under the unit livestock price method, but did not include within such inventory the livestock constituting the breeding herds and held for breeding purposes. Upon audit of the partnership's return for the taxable year 1957, the field agent required the partnership to include in its livestock inventory the raised and also the purchased, livestock held for breeding purposes, and to value same in accordance with the unit livestock price method, and further required the partnership to assign as cost basis for the purpose of computing gain on the sale of such raised breeding animals, the accrued unit values thereof as reflected in such inventory, all as is more fully set forth in Claim for Refund for tax year 1957, filed by taxpayer contemporanously herewith. For the taxable year 1958, the partner, pursuant to and consistent with the handling of its livestock inventory required by the field agent for the taxable year 1957, included in its livestock inventory the livestock constituting the breeding herds and held for breeding purposes, and valued same in accordance with the unit livestock price method, and assigned as cost basis for the purpose of computing gain on the sale of raised breeding animals the accrued unit values thereof as reflected in such inventory; such being done in compliance with and pursuant to instructions and requirements of the Commissioner [fol. 125] of Internal Revenue, but same being erroneous in that:

(a) Livestock raised and held by the partnership for breeding purposes constituted property used in its trade or business within the meaning of Section 1231, I.R.C.

(b) Property used in a trade or business is not property of a kind which would be properly includible in inventory.

(c) The provisions of Regulations 39.22(c)-6 (2)(f), as amended by TD 5423, 1945, CB-70, are contradictory to the provisions of Section 1231, I.R.C. and are invalid. Scofield vs. Lewis, 251 F(2) 128.

(d) Livestock purchased for draft, dairy or breeding purposes had a basis equal to its cost and for purpose of calculating gain on the sale thereof, the partnership is required to use as its basis the depreciated cost of such animals. Raised livestock had no cost basis and, for purposes of calculating gain on the sale thereof, the partnership is required to use a zero basis for such animals.

(e) The partnership was not and is not required to use as the basis the accrued unit values thereof as reflected in such inventory in computing gain on the sale of raised or purchased breeding animals.

The partnership was entitled to treat livestock purchased and held for draft, dairy or breeding purposes as capital assets subject to depreciation; and the partnership is entitled to deduct a reasonable allowance for depreciation on purchased animals held for draft, breeding or dairy purposes.

[fol. 126] The partnership raised, maintained and used a herd of horses in conducting its ranching business. In order to maintain such herd of horses at its normal size, the partnership selected and sold from such herd certain horses which had been held by the partnership at least twelve months next prior to the sale thereof, and which had been actually and substantially used for draft or breeding purposes, and reported the gain thereon as long term capital gain. Upon audit of the return, the Field Agent approved the foregoing, but on review, the Reviewing Agent treated such horses as being primarily held for sale to customers in the ordinary course of business, and adjusted the partnership income and capital gains accordingly, such being erroneous in that such horses had been held for twelve months or more next prior to the sale thereof and were held, and actually and substantially used for draft or breeding purposes, and were not primarily held for sale to customers in the ordinary course of business.

By reason of the erroneous treatment of said livestock and disallowance of the reduction for the expediture made for the Guaranty Fund in calculating the partnership income, all as is more particularly hereinabove set forth, taxpayer's income was erroneously calculated in his individual income tax return and taxpayer is, therefore, entitled to refund as hereinabove and hereinbelow stated.

There is attached hereto Schedule and computations for taxpayer and said partnership to which reference is here made for all purposes, showing the following:

[fol. 127]

Column 1. Computation of partnership income and taxpayer's taxable income and tax as reflected in taxpayer's income tax return as filed, and in the partnership's income tax return as filed.

Column 2. Adjustments made thereto by the filed agent upon audit.

Column 3. Partnership income and taxpayer's taxable income and tax as adjusted by field agent upon audit.

Column 4. Adjustments claimed by taxpayer in the claim for refund.

Column 5. Partnership income and taxpayer's taxable income and tax as claimed in this claim for refund.

Said Schedule and computations attached hereto was incorporated herein and made a part of this Claim for Refund.

[fol. 128]

Addenda to Claim for Refund in re Livestock Inventories:

Taxpayer is entitled to recast the livestock inventory for the year covered by this Claim for Refund and for the years prior thereto, which are open and subject to adjustment, and for all years subsequent thereto, and to remove from both the opening and closing inventories all raised livestock held for breeding purposes and erroneously included therein. In connection with the opening inventory of the earliest year which is open and subject to adjustment (including the year covered by this Claim for Refund, if it be the earliest year open and subject to adjustment), Taxpayer is entitled to a deduction against ordinary income in an amount equal to the accrued unit values of all raised livestock held for breeding purposes therefore erroneously included in such inventory, or, in the alternative, Taxpayer is entitled to amortize an amount equal to the accrued unit values of all raised livestock held for breeding purposes theretofore erroneously included in such inventory, over a period not in excess of five years.

W. H. and Mattye R. Wardlaw (3)
Taxable income and tax
Year ended December 31, 1958

W. P. No.	58-1
ACCOUNTANT	HW
DATE	12/8/61

	Per Return	Difference	Per RAR	Difference	Per Claim
Income:					
Director fees, Del Rio National Bank					
Dividends	106586		106586		106586
Interest	175574		175574		175574
Capital gains or (losses)	855454	(242912)	642942	528502	1171444
Rents and royalties	30067		30067		30067
Estates and trusts	272187		272187		272187
Partnerships:					
Wardlaw Brothers	4494664	629527	5124191	(3401558)	1722633
Jennings Ranch	75839		75839		75839
Other sources:					
W.R.C. Land Company	176491		176491		176491
Adjusted gross income	6217262	386815	6603877	(2865756)	3738121
Deductions and exemptions:					
Standard or itemized deductions:					
Contributions	(19935)		(19935)		(19935)
Interest	(133500)		(133500)		(123500)
Taxes	(10350)		(10350)		(10350)
Personal exemptions	(240000)		(240000)		(240000)
Taxable income	5713477	386815	6130092	(2865756)	3264336
Taxes:					
Income tax	2388925	257579	2646504	(1575336)	1072168
Self employment tax	14175		14175		14175
Dividend received credit	(4263)		(4263)		(4263)
Balance of tax	2398837	257579	2656416	(1575336)	1082080

Wardlaw Brothers, A Partnership (12)
Taxable Income
Year ended December 31, 1958

W. P. No.	58-1
ACCOUNTANT	
DATE	9/21/61

	Per Return	Difference	Per IRAir	Difference	Per Claim	
Profit or (loss) from business:						
Sales	21458297	1214559	22702856	<1214559>	21458297	
less cost of goods sold:						
Inventory at beginning of year	2343174		2343174	<179266 24>	6405120	58-3
Purchases	-0-		-0-			
Labor	487625		487625		487625	
Materials & supplies	445114		445114		445114	
Other	261176		261176		261176	
	3537091		3537091	<179266 24>	1805429	
less inventory at end of year	2708406		2708406	<2331600>	3740200	58-3
cost of goods sold	828685		828685	59873582	1432609	
Gross profit	13201512	1214559	14416071	<720394 1>	7225203	
Deductions						
Rent	275268	—	275268		275268	
Interest	203554	—	203554		203554	
Taxes	37731	—	37731		37731	
Repairs	28147	—	28147		28147	
Depreciation	2068539	<359259>	1709280	1147759	2857039	58-2
Other	145960	—	145960	15219	161179	58-6
Total deductions	8974786	<359259>	8616503	1299953	9915456	
Net profit or (loss)	4226723	1573818	5800541	<8603894>	<2703253>	
Other income:						
Interest	89607	—	89607	—	89607	
Rents and royalties	601376	—	601376	—	601376	
A.C. Program	10000	—	10000	—	10000	
Ordinary income or (loss)	11234659	1573818	12808477	<8603894>	4306583	
Partners' share of ordinary income:						
Walter H. Wardlaw 40%	4494664	629527	5124191	<3401558>	1722633	
Crawford W. Wardlaw 40%	4494664	629527	5124191	<3401558>	1722633	
Trust #1 for Cody H. Wardlaw, Jr. 10%	1123666	157382	1281047	<850389>	430658	
Trust #1 for Tennille Wardlaw 10%	1123665	157382	1281047	<850389>	430658	
	11234659	1573818	12810477	<8603894>	4306583	
Capital gains	4429269	<1214559>	3214710	2679010	5893720	58-4
Partners' share of capital gains:						
Walter H. Wardlaw 40%	1771707	<485823>	1285884	1071604	2357488	
Crawford W. Wardlaw 40%	1771708	<485824>	1285884	1071604	2357488	
Trust #1 for Cody H. Wardlaw, Jr. 10%	442927	<121456>	321471	267901	589372	
Trust #1 for Tennille Wardlaw 10%	442927	<121456>	321471	267901	589372	
	4429269	<1214559>	3214710	2679010	5893720	

✓ Exhibit T to Stipulation of Facts

✓ Exhibit T to Stipulation of Facts

FORM 843
(Rev. Mar. 1960)

U. S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

District Director's Stamp
(Date received)

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- [x] Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- [ ] Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- [ ] Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
W. H. and MAYME J. WARDLAW

Number and street
Box 1112

City, town, postal zone, State
Del Rio, Texas

Fill in applicable items—Attach letter size sheets if space is not sufficient

1. Social security number

2. If an employer, enter employer identification number

3. District in which return (if any) was filed
U.S. Collector of Internal Revenue
San Antonio, Texas

4. Name and address shown on return, if different from above
Same

5. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 19 59 To December 31, 19 59

6. Kind of tax
Income

7. Amount of assessment
$ 20,220.27

Dates of payment

8. Date stamps were purchased from Government

9. Amount to be refunded
$ 34,237.64*

10. Amount to be abated (not applicable to income, estate, or gift taxes)
$

11. The claimant believes that this claim should be allowed for the following reasons:

*Or such greater or lesser amount as may be legally refundable, plus interest.

See statement attached.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed W. H. Wardlaw

Dated April 30, 1962 MAYME J. WARDLAW

INSTRUCTIONS

1. The claim must set forth in detail each ground upon which it is made and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. If a joint income tax return was filed for the year for which this claim is filed, enter social security and employer identification number, if any, of both husband and wife and each must sign this claim even though only one had income.

3. Whenever it is necessary to have the claim executed by an agent on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent to sign the claim on behalf of the taxpayer shall accompany the claim.

4. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

5. Where the taxpayer is a corporation, the claim will be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

6. If claim is for excess social security (F.I.C.A.) tax withheld as a result of having had more than one employer, include the names and addresses of your employers, and the amount of wages received and taxes withheld by each as part of your explanation in item 11. Do not claim tax withheld if you have claimed the excess withholding on your individual income tax return.

FORM 843 (Rev. 3-60)

Exhibit T

[fol. 131]

[fol. 132] Taxpayer is a partner in the partnership of Wardlaw Brothers, which conducts a ranching business consisting of breeding and raising sheep, goats, cattle and horses, principally for the production of wool, mohair, mutton, calves and colts.

During the taxable year 1957, the partnership carried its livestock held for sale on an inventory basis and valued such livestock under the unit livestock price method, but did not include within such inventory the livestock constituting the breeding herds and held for breeding purposes, Upon audit of the partnership's return for the taxable year 1957, the field agent required the partnership to include in its livestock inventory the raised and also the purchased, livestock held for breeding purposes, and to value same in accordance with the unit livestock price method, and further required the partnership to assign as cost basis for the purpose of computing gain on the sale of such raised breeding animals, the accrued unit values thereof as reflected in such inventory, all as is more fully set forth in Claim for Refund for tax year 1957, filed by taxpayer contemporanously herewith. For the taxable year 1958, the partner, pursuant to and consistent with the handling of its livestock inventory required by the field agent for the taxable year 1957, included in its livestock inventory the livestock constituting the breeding herds and held for breeding purposes, and valued same in accordance with the unit livestock price method, and assigned as cost basis for the purpose of computing gain on the sale of raised breeding animals the accrued unit values thereof as reflected in such inventory; such being done in compliance with and pursuant to instructions and requirements of the Commissioner [fol. 133] of Internal Revenue, but same being erroneous and taxpayer entitled to a refund, as set forth in Claim for Refund, for the year 1958, filed contemporaneously herewith. For the taxable year 1959, the partnership, pursuant to and consistent with, the handling of its livestock inventory required by the field agent for the taxable years 1957 and 1958, included in its livestock inventory the livestock constituting the breeding herds and held for breeding purposes, and valued same in accordance

with the unit livestock price method, and assigned as cost basis for the purpose of computing gain on the sale of raised breeding animals the accrued unit value thereof as reflected in such inventory; such being done in compliance with and pursuant to instructions and requirements of the Commissioner of Internal Revenue, but same being erroneous in that:

(a) Livestock raised and held by the partnership for breeding purposes constituted property used in its trade or business within the meaning of Section 1231, I.R.C.

(b) Property used in a trade or business is not property of a kind which would be properly includible in inventory.

(c) The provisions of Regulations 39.22(c)-6 (2)(f), as amended by TD 5423, 1945, CB-70, (now Reg. 1.47-6 (f)) are contradictory to the provisions of Section 1231, I.R.C. and are invalid, *Scofield* vs. *Lewis*, 251 F(2) 128.

(d) Livestock purchased for draft, dairy or breeding purposes had a basis equal to its cost and for purpose of calculating gain on the sale thereof, the partnership [fol. 134] is required to use as its basis the depreciated cost of such animals. Raised livestock had no cost basis and, for purposes of calculating gain on the sale thereof, the partnership is required to use a zero basis for such animals.

(e) The partnership was not and is not required to use as the basis the accrued unit values thereof as reflected in such inventory in computing gain on the sale of raised or purchased breeding animals.

The partnership was entitled to treat livestock purchased and held for draft, dairy or breeding purposes as capital assets subject to depreciation; and is entitled to deduct a reasonable allowance for depreciation on purchased animals held for draft, breeding or dairy purposes.

The partnership raised, maintained and used a herd of horses in conducting its ranching business. In order to maintain such herd of horses at its normal size, the partnership selected and sold from such herd certain horses which had been held by the partnership at least twelve months next prior to the sale thereof, and which had

been actually and substantially used for draft or breeding purposes, and reported the gain thereon as long term capital gain. Upon audit of the return, the Field Agent approved the foregoing, but on review, the Reviewing Agent treated such horses as being primarily held for sale to customers in the ordinary course of business, and adjusted the partnership income and capital gains accordingly, such being erroneous in that such horses had been held for twelve months or more next prior to the sale thereof and were held, and actually and substantially used for draft or breeding purposes, and were not prim- [fol. 135] arily held for sale to customers in the ordinary course of business.

By reason of the erroneous treatment of said livestock and disallowance of the reduction for the expenditure made for the Guaranty Fund in calculating the partnership income, all as is more particularly hereinabove set forth, taxpayer's income was erroneously calculated in his individual income tax return and taxpayer is, therefore, entitled to refund as hereinabove and hereinbelow stated.

GUARANTY FUND DEDUCTION:

During the taxable year 1957, the partnership contributed the sum of $122,975.00 to the Guaranty Fund of the Del Rio National Bank under the circumstances set out in statement attached to claim for refund for 1957, filed by taxpayer contemporaneously herewith and the partnership claimed a deduction therefor which was subsequently disallowed as therein stated. The administration of the Guaranty Fund under the terms of the Indenture creating same, terminated on June 19, 1959, and at such date it was determined that a net loss in the aggregate amount of 56.7% of the contributions to the Guaranty Fund had been sustained by the contributors thereto. The partnership deducted such proportion of its contribution to the Guaranty Fund in its income tax return for 1959. Upon audit of the return for said year, the field agent disallowed the deduction which was subsequently affirmed upon review. The partnership is entitled to the deduction for the contributions to the Guaranty Fund as

set forth in its claim for refund for the year 1957 filed [fol. 136] contemporaneously herewith or, in the alternative, that is entitled to deduct 56.7% (being the amount irrevocably appropriated by the Trustees of the Guaranty Fund pursuant to the Indenture creating same) of the original contribution thereto, in that such expenditure was made by the partnership under the circumstances set forth in Claim for Refund for the year 1957, filed contemporaneously herewith, for the purpose of promoting or protecting its business and same constitutes an ordinary and necessary expense paid during the taxable year in carrying on its trade or business within the meaning of I.R.C., Sec. 162(a), or in the alternative, that the partnership is entitled to deduct a net loss sustained in 1959 in the amount of 56.7% of its contribution to the Guaranty Fund upon the ground that same constitutes a loss not compensated for by insurance or otherwise within the meaning of I.R.C. Sec. 165(a).

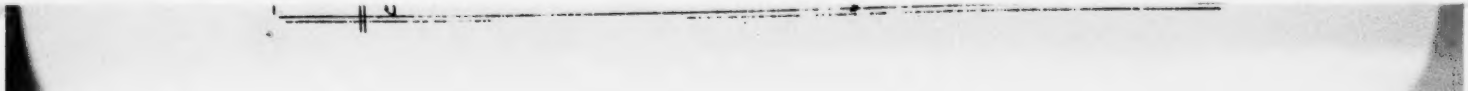
There is attached hereto Schedule and computations to which reference is here made for all purposes, showing the following:

Column 1. Computation of partnership income and taxpayer's taxable income and tax as reflected in the partnership and taxpayer's income tax return as filed.

Column 2. Adjustments made thereto by the field agent upon audit.

Column 3. Partnership income and taxpayer's taxable income and tax as adjusted by field agent upon audit.

Column 4. Adjustments claimed by taxpayer in the claim for refund.



W. H. and Hattie C. Wardlaw (2)
Taxable income and income tax
Year ended December 31, 1959

W. P. No.	59-1
ACCOUNTANT	HW
DATE	12/2/61

	Per Return	Difference	Per RAR	Difference	Per claim
Income:					
Dividends	264048		264048		264048
Interest	182593		182593		182593
Capital gains or (losses)	642139	(254539)	387600	621407	1009007
Rents and royalties	3105777		3105777		3105777
Estates and Trusts	892850		892850		892850
Partnerships:					
Wardlaw Brothers	1508701	3334240	4842941	(5931988)	(1089047)
(Farming) Ranch	90750		90750		90750
Other sources:					
W. B. C. Land Co.	357510		357510		357510
Adjusted gross income	7044368	3079701	10124069	(5310581)	4813488
Deductions and exemptions:					
Standard or itemized deductions:					
(No details)	(204318)		(204318)		(204318)
Personal exemptions	(240000)		(240000)		(240000)
Taxable income	6600050	3079701	9679751	(5310581)	4369170
Taxes:					
Income Tax	2938974	2109175	5048149	3423564	1624585
Self-employment tax	18000		18000		18000
Dividends received credit	(10562)		(10562)		(10562)
Balance of tax	2946412	2109175	5055587	(3423564)	1632023

Wardlaw & others, A Partnership (a)
Taxable Income
Year ended December 31, 1959

W. P. No.	59-1
ACCOUNTANT	(GK)
DATE	12/2/61

	Per Return	Difference	Per R.A.R.	Difference	Per Claim
Profit or (loss) from business & sales	30721969	1265194	31987163	(1265194)	30721969
Less cost of goods sold:					
Inventory at beginning of year	24268906	-	24268906	(2050706)	3768200
Purchases	-				
Labor	14041160	-	14041160	-	14041160
Materials and supplies	-				
Other	-				
	38310066	-	38310066	(2050706)	17809360
Less inventory at end of year	28346356	-	28346356	(2481136)	3534520
Cost of goods sold	9963710	-	9963710	481130	14274840
Gross profit	20758259	1265194	22023453	(5576324)	16447129
Deductions:					
Rent	3550254	-	3550254		3550254
Interest	1189309	-	1189309		1189309
Taxes	442617	-	442617		442617
Repairs	632911	-	632911		632911
Depreciation	2420048	(327687)	2092361	666963	2759324
Bad debts	674719	(674719)	- -	674719	674719
Other	277429	-	277429	1844065	4618194
Total deductions	17751987	(7070406)	10681581	9253647	19935228
Net profit or (loss)	3006272	8335600	11341872	(14829771)	(3488099)
Other income					
Miscellaneous income	390145	-	390145	-	390145
Interest	375336	-	375336	-	375336
Ordinary income or (loss)	3771753	8335600	12107353	(14829771)	(2722618)
Partners share of ordinary income:					
Walter H. Wardlaw 40%	150870 1	333424 0	484294 1	(593198 8)	(108904 7)
Crawford W. Wardlaw 40%	150870 1	333424 0	484294 1	(593198 8)	(108904 7)
Trust #1 for Tennille Wardlaw 20%	75435 1	166712 0	242147 1	(296599 5)	(54452 34)
	3771753	8335600	12107353	(14829771)	(2722618)
Capital gains	337052 0	(126519 4)	2105326	3107034	512360
Partners share of capital gains:					
Walter H. Wardlaw 40%	134820 8	(50607 7)	842131	124281 3	2084944
Crawford W. Wardlaw 40%	134820 8	(50607 7)	842131	124281 3	2084944
Trust #1 for Tennille Wardlaw 20%	67410 4	(25304 0)	421064	62140 8	1042972
	337052 0	(126519 4)	2105326	3107034	512360

[fol. 139]

Column 5. Partnership income and taxpayer's tax able income and tax as claimed in this claim for refund.

Said Schedule and computations attached hereto was incorporated herein and made a part of this Claim for Refund.

Addenda to Claim for Refund in re Livestock Inventories:

Taxpayer is entitiled to recast the livestock inventory for the year covered by this Claim for Refund and for the years prior thereto, which are open and subject to adjustment, and for all years subsequent thereto, and to remove from both the opening and closing inventories all raised livestock held for breeding purposes and erroneously included therein. In connection with the opening inventory of the earliest year which is open and subject to adjustment (including the year covered by this Claim for Refund, if it be the earliest year open and subject to adjustment), Taxpayer is entitled to a deduction against ordinary income in an amount equal to the accrued unit values of all raised livestock held for breeding purposes therefore erroneously included in such inventory, or, in the alternative, Taxpayer is entitled to amortize an amount equal to the accrued unit values of all raised livestock held for breeding purposes theretofore erroneously included in such inventory, over a period not in excess of five years.

[fol. 140]

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF TEXAS
DEL RIO DIVISION

CIVIL ACTION

No. 307

W. H. WARDLAW and wife, MATTYE GWEN WARDLAW, PLAINTIFFS

vs.

UNITED STATES OF AMERICA, DEFENDANT

FINAL JUDGMENT—January 31, 1964

All of the issues involved in the above numbered and entitled cause with respect to the determination of Plaintiffs' inventory of livestock and the calculation of gain upon the sale of livestock held for breeding purposes having been by order of this Court severed from the other issues involved therein for trial separately by the Court without a jury, same came on for consideration in the United States District Court for the Western District of Texas, Del Rio Division, sitting in San Antonio, Texas, on the 3rd day of May, 1963, upon Plaintiffs' Motion for Summary Judgment, and Defendant's Motion for Summary Judgment, and the Court having considered the pleadings filed in this action, the Stipulations of Fact entered into between Plaintiffs and Defendant, the respective Motions for Summary Judgments filed herein by Plaintiffs and by Defendant, and the written briefs and oral argument of Plaintiffs and Defendant submitted in support thereof, and the Court being fully advised in the premises and there being no dispute as to any material fact, the Court made and filed its Findings of Fact and [fol. 141] Conclusions of Law herein, expressly directing that judgment be entered herein in accordance therewith, and there being no just reason for the delay in the entry of judgment herein;

It is THEREFORE ORDERED, ADJUDGED and DECREED that Plaintiffs' Motion for Summary Judgment with respect to raised animals held for breeding purposes be and the same is hereby granted, but insofar as same relates to purchased animals held for breeding purposes, Plaintiffs' Motion for Summary Judgment be, and the same is hereby denied; and

It is further ORDERED, ADJUDGED and DECREED that Defendant's Motion for Summary Judgment with respect to raised animals held for breeding purposes be and the same is hereby denied, but insofar as same relates to purchased animals held for breeding purposes, Defendant's Motion for Summary Judgment be and the same is hereby granted; and

It is further ORDERED, ADJUDGED and DECREED by the Court that Plaintiffs W. H. WARDLAW and wife, MATTYE GWEN WARDLAW, do have and recover from Defendant, the UNITED STATES of AMERICA the sum of $39,798.68 (which sum represents overpayment of income tax for Plaintiffs' taxable years 1957, 1958 and 1959) with interest at the rate of 6% per annum on the amount of $6,760.37 from April 15, 1958; on the amount of $21,288.00 from April 15, 1959; and on the [fol. 142] amount of $11,750.31 from April 15, 1960, together with all allowable costs of suit expended by Plaintiffs herein.

DONE and ENTERED this the 31st day of January 1964.

/s/ ADRIAN A. SPEARS
U. S. District Judge

Approved as form

WILLIAM O. MURRAY, JR.
1st Asst. U. S. Attorney

* * * *

[fol. 143]

IN THE UNITED STATES DISTRICT COURT,
WESTERN DISTRICT OF TEXAS
DEL RIO DIVISION

CIVIL ACTION

No. 307

W. H. WARDLAW and wife MATTYE GWEN WARDLAW
PLAINTIFF

vs.

UNITED STATES OF AMERICA, DEFENDANT

NOTICE OF APPEAL

Notice is hereby given that the defendant herein hereby appeals to the United States Court of Appeals for the Fifth Circuit from the final judgment entered in this action on January 31, 1964.

ERNEST MORGAN
United States Attorney

By: /s/ TED BUTLER
TED BUTLER
Assistant U. S. Attorney
Post Office Box 1701
San Antonio, Texas, 78206

[fol. 144]

CERTIFICATE OF SERVICE BY MAIL

This is to certify that a copy of the foregoing Notice of Appeal has been served on opposing counsel by depositing a copy of same in the United States Mails, postage prepaid, addressed to Mr. Elwood Cluck, attorney at Law, 2100 National Bank of Commerce Building, San Antonio, Texas, on this the 27th day of March, 1964.

/s/ TED BUTLER
TED BUTLER
Assistant U. S. Attorney

[fols. 145-152] * * *

[fol. 153]

MINUTE ENTRY OF ARGUMENT AND SUBMISSION—
January 6, 1965.

(Omitted in Printing)

[fol. 154]

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 21607

UNITED STATES OF AMERICA, APPELLANT-APPELLEE

vs.

W. H. WARDLAW, Independent Executor of the Estate of C. H. Wardlaw, Deceased, ET AL., APPELLEES-APPELLANTS

(AND REVERSE TITLE)

Appeals from the United States District Court for the Western District of Texas.

OPINION—April 8, 1965.

Before MARIS,* RIVES and BROWN, Circuit Judges.

PER CURIAM: This appeal and cross appeal presents Taxpayer's and the Government's dissatisfaction with the trial Court's disposition of the tax refund suit. We affirm.

[fol. 155] At issue is the proper income tax treatment of *raised* breeding animals and *purchased* breeding animals owned by an accrual basis Taxpayer-Rancher.

The Government's appeal concerns *raised* breeding animals.[1] The District Court followed our opinion in *Scofield* v. *Lewis*, 1958, 251 F.2d 128, which held that Treasury

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* Of the Third Circuit, setting by designation.

[1] The same issue is now pending before another panel of this Court in United States v. Catto, No. 21351, 1965, . . . F.2d . . .

Regulation 1.471-6(f) was invalid. Despite the doubts generated by express rejection of *Lewis* by the 8th and 9th Circuits,[2] a somewhat restricted reading of it by us in *Carter* v. *Commissioner*, 5 Cir., 1958, 257 F.2d 595, and the impressive conceptual arguments perhaps not fully advanced earlier, we recognize that *Lewis* is directly in point and is, and must be, controlling until the principle is judicially reversed or legislatively repealed.[3]

The Taxpayer's appeal concerns *purchased* breeding animals. Accrual basis livestock farmers under Treas. [fol. 156] Reg. 1.471-6(g) (1954 Code) are given an option to include in inventory their purchased breeding animals, or to treat them as capital assets subject to depreciation. Taxpayer here, prior to 1957, had been including purchased animals in inventory, but, without the Commissioner's consent, elected in the years 1957, 1958, 1959 to exclude purchased animals from inventory so as to (a) depreciate their cost basis and (b) upon sale report capital gain against depreciated cost rather than inventory value. The District Court sustained the Commissioner's refusal to permit this.

The difference between Taxpayer and the Government is a narrow one. Taxpayers recognize that the option has to be exercised and that once exercised as to a particular animal, that animal cannot be changed from inventory to depreciable asset, or vice versa. The Government urges that it is the practice with respect to the herd. We agree.

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[2] United States v. Ekberg, 8 Cir. 1963, 291 F.2d 913; Banks v. Commissioner, 8 Cir. 1963, 322 F.2d 530, 546-47; Little v. Commissioner, 9 Cir., 1963, 294 F.2d 661; see also Irvine v. Commissioner, D.C. Wyo., 1963, 212 F.Supp. 937.

[3] Congress, at least since 1952, has been aware of many of these problems. See letter of June 27, 1952, from Secretary of the Treasury to Senator George, Chairman of the Senate Finance Committee, 98 Cong. Record, part 6, pp. 8307-8308. One complicating factor is the practice, recognized by formal regulations by which both accrual and cash basis taxpayers may deduct the cost of feeding, raising and maintaining animals as ordinary and necessary business expense rather than treating them as capital expenditure for the "acquisition" of a capital asset, i.e., a mature animal. Treasury Regulation 1.162-12. This regulation, with only slight terminology changes, goes back to 1921. See, e.g., Regulation 45, Art. 110, for the year 1921; Reg. 101, Art. 23(a)-11, for the year 1936.

The Regulations, § 1.61-4(b)[4] require a consistency from year to year and as such represent a valid exercise of the Commissioner's power to prescribe reasonable accounting methods, *Cf. Carter* v. *Commissioner*, 5 Cir., 1958, 257 F.2d 595. We are not impressed with Taxpayer's argument that it was 1960 before it was learned for the first time that only one election is afforded. The Regulation is plain and administratively reasonable. [fol. 157] "There is no evidence that Ruling 60-60 departed from any prior construction of the applicable statutes and regulations." *Tee Bar Ranch Co.* v. *United States*, D. Mont., 1963, 63-2 USTC #9663, at 98,681 and authority there collected.

AFFIRMED.

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[4] § 1.61-4(b). "A farmer using accrual method of accounting must use inventories to determine his gross income * * *. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory * * * instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. * * *."

[fol. 158]

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term, 1964

No. 21607

D. C. Docket Nos. 306, 307, 328, 329, 330, 331, 332 and 333-C. A.

UNITED STATES OF AMERICA, APPELLANT-APPELLEE

versus

W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. H. WARDLAW, DECEASED, ET AL., APPELLEES-APPELLANTS

(AND REVERSE TITLE)

Appeal from the United States District Court for the Western District of Texas.

Before MARIS,* RIVES and BROWN, Circuit Judges.

JUDGMENT—April 8, 1965

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

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* Of the Third Circuit, sitting by designation.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

Issued as Mandate: May 3, 1965

[fol. 159]

[Clerk's Certificate to foregoing transcript omitted in printing]

[fol. 160]

SUPREME COURT OF THE UNITED STATES

No. ————, October Term, 1965

UNITED STATES, PETITIONER

v.

JOHN CATTO, JR., and ROXANA CATTO

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—July 2, 1965

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing a petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including August 6, 1965.

/s/ Hugo L. Black
Associate Justice of the Supreme Court of the United States

Dated this 2nd day of July, 1965

[fol. 161]

SUPREME COURT OF THE UNITED STATES

No. ————, October Term, 1965

UNITED STATES, PETITIONER

v.

W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. H. WARDLAW, DECEASED, ET AL.

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—July 2, 1965

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing a petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including August 6, 1965.

/s/ Hugo L. Black
Associate Justice of the Supreme
Court of the United States

Dated this 2nd day of July, 1965

[fol. 162]

SUPREME COURT OF THE UNITED STATES

No. ————, October Term, 1965

UNITED STATES, PETITIONER

vs.

JOHN CATTO, JR. AND ROXANA CATTO, HIS WIFE.

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—July 30, 1965

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing a petition for writ of certiorari in the above-entitled cause be, and the same is hereby, further extended to and including Sept. 5, 1965.

/s/ Hugo L. Black
Associate Justice of the Supreme
Court of the United States

Dated this 30th day of July, 1965

[fol. 163]

SUPREME COURT OF THE UNITED STATES

No. ———, October Term, 1965

UNITED STATES, PETITIONER

vs.

W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. H. WARDLAW, DECEASED, ET AL.

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—July 30, 1965

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing a petition for writ of certiorari in the above-entitled cause be, and the same is hereby further extended to and including Sept. 5, 1965.

/s/ Hugo L. Black
Associate Justice of the Supreme Court of the United States

Dated this 30th day of July, 1965

[fol. 164]

SUPREME COURT OF THE UNITED STATES

No. 535, October Term, 1965

UNITED STATES, PETITIONER

v.

JOHN CATTO, JR., ET AL.

ORDER ALLOWING CERTIORARI—November 22, 1965.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1965 797083 417

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In the Supreme Court of the United States

OCTOBER TERM, 1965

No.

UNITED STATES OF AMERICA, PETITIONER

v.

JOHN CATTO, JR. AND ROXANA CATTO

UNITED STATES OF AMERICA, PETITIONER

v.

W. H. WARDLAW, Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Fifth Circuit in the above-entitled cases.

OPINIONS BELOW

The district court did not file an opinion. Its findings of fact and conclusions of law in *United States*

v. *Catto* (R. 38-49),[1] are reported at 223 F. Supp. 663, and in *United States* v. *Wardlaw* (R. 3-20) at 223 F. Supp. 631. The respective *per curiam* opinions of the colurt of appeals (Appendix A, *infra*, pp. 18-21, 23-25) are reported at 344 F. 2d 227 and 344 F. 2d 225.

JURISDICTION

The judgments of the courts of appeals were entered on April 8, 1965 (Appendix A, *infra*, pp. 22, 26). Mr. Justice Black extended the time for filing a petition for a writ of certiorari to and including September 5, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Ranchers are, in general, entitled to capital gain on profits from the sale of breeding livestock which they use to produce animals marketed for purposes of slaughter. Long-standing Treasury Regulations require taxpayers who (like those involved in the instant cases) follow one of the variants of the accrual method of accounting to capitalize the costs of raising breeding livestock and then to report as capital gain the excess of the animals' sales proceeds over their cost basis. The taxpayers consistently complied with these regulations, but subsequently brought suits for refunds claiming the right (1) to deduct against ordinary income all of the costs of raising their breeding animals, thus giving them a zero cost basis in the

[1] "R." references are to the printed records in the court of appeals.

livestock and (2) to report the full proceeds of sale as capital gain. The questions presented are:

1. Whether, contrary to Treasury Regulations which the court below held invalid, ranchers using the unit-livestock-price variation of the accrual method of accounting may transform ordinary income into capital gain by deducting against current income the accumulated cost (basis) of raising breeding livestock and then reporting the entire proceeds from their sale as capital gain.

2. Whether a court may permit taxpayers to revise materially their consistent method of reporting income by adopting a hybrid system when those taxpayers did not first make application to the Commissioner for permission to change their method of accounting as required by the Internal Revenue Code of 1954, § 446(e).

STATUTES AND REGULATIONS INVOLVED

Sections 446(e), and 1231(a) and (b)(3) of the Internal Revenue Code of 1954, and Sections 1.61-4, 1.162-12, 1.167(a)-6(b), 1.446-1(e)(2)(i), and 1.471.6 of the Treasury Regulations (1954 Code), appear in Appendix B, *infra*, pp. 36-44.

STATEMENT

The pertinent facts in both suits were stipulated and are substantially the same. For the most part, it will be unnecessary to distinguish between them. The taxpayers are ranchers who raise livestock for

sale.[2] As an incident of this business they also raise breeding cattle which they use to produce beef animals. Each of the taxpayers elected to report his income on a variant of the accrual method of accounting, called the unit-livestock-price method. This method (as explained in more detail, *infra*) permits the taxpayer to use estimates in lieu of the actual cost of raising cattle for purposes of valuing cattle on hand at the end of the tax year. As required by the Regulations, the taxpayers consistently used this estimated-cost method of accounting for both the beef and breeding cattle which they raised. (Catto R. 40; Wardlaw R. 8, 10.)

During the years here in question taxpayers sold some animals which they had held for breeding purposes for more than 12 months and reported the profit as capital gain under Section 1231 of the 1954 Code. They computed the gain on these sales by deducting from the sales proceeds the cost basis of the breeding cattle sold (calculated according to the taxpayers' estimated-cost method of accounting). However, the taxpayers thereafter filed claims for refund, contending that they should not have capitalized the cost of

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[2] Eight cases were consolidated for trial in *United States* v. *Wardlaw;* that case and *United States* v. *Catto,* have been consolidated herein. The years involved vary from case to case, but cover 1954 through 1959, inclusive (Catto R. 39; Wardlaw R. 7). The various taxpayers raise cattle, sheep and goats (Catto R. 40; Wardlaw R. 8). The legal principles are the same regardless of which animals are involved. For simplicity, this petition will refer to them all as cattle; and the term "beef cattle" will be used to mean livestock which are marketed for purposes of slaughter.

raising their breeding cattle. They argued (1) that the entire accumulated cost of the breeders should be deducted against ordinary income, thus giving them a zero cost basis in the cattle, and (2) that the entire proceeds from the sale of the cattle should be capital gain. At no time, however, did any of the taxpayers request the Commissioner's permission to change their method of accounting. The Commissioner rejected the refund claims. (Catto R. 43-45; Wardlaw R. 12-13.) The taxpayers then sued for a refund and the district court rendered judgment in their favor (Catto R. 50; Wardlaw R. 1, 20, 140). The Fifth Circuit affirmed *per curiam* on the authority of its earlier decision in *Scofield* v. *Lewis*, 251 F. 2d 128 (App. A, *infra*, pp. 27-35), and held invalid the Treasury Regulation requiring accrual basis ranchers on the unit-livestock-price method of accounting to accumulate the estimated cost of raising breeding cattle (App. A, *infra*, pp. 20-21, 23-24).

REASONS FOR GRANTING THE WRIT

1. The Fifth Circuit's decisions in the instant cases are in direct conflict with decisions of the Courts of Appeals for the Eighth and Ninth Circuits. *United States* v. *Ekberg*, 291 F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920, and *Little* v. *Commissioner*, 294 F. 2d 661 (C.A. 9).[3]

The first case decided on the point involved in the instant cases was *Scofield* v. *Lewis*, 251 F .2d 128,

[3] See also *Irvine* v. *United States*, 212 F. Supp. 937 (D. Wyo.); *Frost* v. *Commissioner*, 28 T.C. 1118.

in which the Fifth Circuit held against the government. However, shortly thereafter the Fifth Circuit cast doubt on the validity of its own *Lewis* holding by stating that "the principle of the *Lewis* case should not be extended beyond its own facts." *Carter* v. *Commissioner*, 257 F. 2d 595, 600. When the Eighth and Ninth Circuits thereafter held for the government on the same issue, we successfully opposed certiorari on the ground, *inter alia*, that the Fifth Circuit's view was in doubt. The instant decisions of the Fifth Circuit, however, remove all question as to the existence of a clear and direct conflict. Unless the conflict is resolved, ranchers in the Eighth and Ninth Circuits will be taxed differently from the vast number of livestock raisers located in the Fifth Circuit.

2. The instant decisions erroneously held invalid a Treasury Regulation of long standing.

Most ranchers, in addition to raising beef cattle, raise breeding cattle which, when they reach maturity, are used to produce the rancher's beef cattle. The Internal Revenue Code treats the beef cattle like the inventory of a manufacturing concern; the rancher thus pays an ordinary income tax on the profits from their sale. Breeding cattle, however, are generally not held for sale to customers but are used by the taxpayer in producing property (*i.e.*, beef cattle) to be sold to customers; thus, gain from the sale of breeders, like profit on the sale of plant and machinery, is taxed as capital gain. Internal Revenue Code of 1954, § 1231(a), (b)(3), App. B, *infra*, pp. 36-37.

The Treasury Regulations attempt to give ranchers (and farmers) the widest possible choice between a simplified method of computing gains (the cash receipts and disbursements basis) and a more sophisticated method of accounting (the accrual basis). Treas. Reg. § 1.471-6, App. B, *infra*, pp. 41-44.[4] If a rancher selects the accrual system, he is required by the Regulations to maintain an inventory of cattle on hand and to capitalize the cost (or estimated cost) of his breeding and beef herds. Treas. Reg. § 1.61-4(b), App. B, *infra*, pp. 38-39. Because of the complexities of the cattle industry, the Regulations give an accrual basis rancher a number of alternative ways to value his livestock on hand at the beginning and end of his tax year. Treas. Reg. § 1.471-6(c), (h), App. B, *infra*, pp. 41-43. The valuation of cattle on hand is crucial to the computation of profit or loss: To the extent that the value of cattle on hand at the end of the tax year has increased from the beginning of the year, expenditures for feed, etc. are not currently deductible but are capitalized and thus increase the taxpayer's cost basis in the cattle. Treas. Reg. §§ 1.61-4(b), 1.162-12, App. B, *infra*, pp. 38-39. The cost basis (as annually augmented by those expenditures which are not currently deducted) is then used to determine gain on sale of the animals, which in the case of breeding cattle held for at least 12 months constitutes capital gain. Internal Revenue Code of 1954, §§ 1011-1013, 1016, 1231. For example, assume that a rancher's cattle on hand at the

[4] Citations to the Treasury Regulations are to those promulgated under the Internal Revenue Code of 1954.

beginning of the year were valued at $100, that he expended $100 in raising his animals during the year, and that his unsold cattle at the end of the year were valued at $140. Since his inventory increased in value by $40, $40 of the $100 expended during the year would be nondeductible, *i.e.*, it would be added to the cost basis of his cattle on hand (capitalized). The other $60 (the costs of raising the cattle which were sold) would be deducted from the proceeds of sale to determine gain (capital or ordinary, depending on the type of animals sold).

Because it is extremely difficult as a practical matter for a rancher to accurately allocate his costs among his various operations, the Regulations permit (but do not require) him to elect a special method of estimated-cost accounting, called the "unit-livestock-price" method. Treas. Reg. § 1.471-6(c). Its purpose is to reach the same approximate result as an actual cost method, but to use a series of estimates in order to simplify the required record keeping and allocation tasks. All of the taxpayers involved in the instant cases were on the unit-livestock-price variation of the accrual method of accounting (Catto R. 40; Wardlaw R. 10). Under this method the taxpayer estimates the amount it costs him to raise his cattle to various stages of development and establishes a "standard unit price" for each class of animal. At the end of each tax year he counts the number of head on hand in each category and values them according to his established estimates (which remain constant from year to year). Treas. Reg. § 1.471-6(e), (f), (h). Then the taxpayer takes a deduc-

tion on his tax return for all expenses incurred during the year in raising his cattle but reduces this deduction by (*i.e.*, adds to income) the increase in the value of his cattle on hand at the end of the year over his cattle on hand at the beginning of the year, both valued according to the estimated-cost method. Treas. Reg. §§ 1.162-12, 1.61-4(b). If the taxpayer has chosen accurate estimates of his costs, this method will produce the same result as using actual costs.

For an illustration of this method as it works with respect to beef cattle, assume that a taxpayer estimates that it costs him $10 per year to raise an animal. Assume, also, that at the beginning of the year he had on hand 10 one-year olds, that he expended $100 in raising his animals during the year, and that just before year end he sold three, so that at the end of the year he still owned 7 two-year-olds. The value of his cattle at the beginning of the year was $100 (10 x $10). The value of his cattle at the year end was $140 (7 x $20). His inventory increased in value by $40, so $40 of the $100 expended during the year would be capitalized and the other $60 would be deducted from ordinary income. The $60 deduction comprises both the cost basis at the beginning of the year of the three head sold (3 one-year olds at $10) and the $30 spent on them during the year. The $140 of cattle still on hand is composed of $70 from opening inventory (7 one-year olds at $10) plus the $70 spent on them during the year.

The Regulations provide that if a taxpayer chooses to use the unit-livestock method of accounting he must use it consistently for both his beef animals and his

breeding herd. Treas. Reg. § 1.471-6(f). Thus as the rancher raises a breeder he accumulates his estimated costs; and when he sells an animal which has become too old to be useful in breeding, he uses the accumulated estimated cost of raising the animal as his basis for computing capital gain.[5] Internal Revenue Code of 1954, §§ 1011-1013, 1016. For example, if the taxpayer has estimated that it costs $100 to raise a breeder to maturity, $100 of his expenditures is capitalized as the cost basis of the animal (*i.e.*, $100

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[5] In general the Treasury Regulations permit accrual basis ranchers to depreciate either purchased or raised breeding cattle used in their trade or business. Beginning with a breeding animal's maturity a rancher, under generally accepted principles, is permitted to depreciate the excess of its cost basis over its estimated salvage value. Treas. Reg. §§ 1.61-4(b), 1.167(a)-6(b), App. B, *infra*, pp. 38, 40. However, because breeding animals can be sold for their beef value at the end of their useful lives as breeders, the cost of raising a breeding animal almost always approximates or is less than its estimated salvage value. This is especially true of those taxpayers who use the unit-livestock-price method of valuing their cattle; standard unit costs (used to value cattle on hand) have remained constant over the years while actual costs and salvage values have risen because of inflation. Thus as a practical matter only purchased breeders (for which thousands of dollars are sometimes paid) are depreciable, and raised breeders (for which at most a few hundred dollars of raising costs were expended) are not. This explains the requirement that a rancher who elects the unit-livestock-price method of accrual accounting must "inventory" his raised breeding cattle on the unit-livestock-price method of valuation (see Treas. Reg. §§ 1.471-6(f), (g), 1.162-12; Mim. 5790, 1945 Cum. Bull. 72). The designation "inventory" merely prevents him from depreciating raised breeding cattle, which as a practical matter he could not depreciate anyway, and has no other effect.

of his expenditures is not deducted as incurred); if the animal is ultimately sold for $150, the taxpayer recognizes a $50 capital gain on sale.[6]

The Fifth Circuit in the instant cases did not disagree with the Commissioner's contention that these Regulations were a logical and reasonable method of taxing accrual basis taxpayers. Rather, the court held that the Regulation was invalid because it did not afford accrual basis ranchers the same windfall that cash basis taxpayers receive (App. A, *infra*, pp. 20-21, 24). The Regulations permit a cash basis rancher to deduct annually all of his expenses of raising both beef and breeding cattle. He is not required to maintain any inventory or to capitalize any of his costs. Treas. Reg. §§ 1.162-12, 1.61-4(a), App. B, *infra*, pp. 37-38, 39. Thus a rancher on the cash method of accounting has a zero cost basis for his animals, and when he sells a breeder the full proceeds of sale are capital gain. He obtains an unwarranted tax advantage by deducting from ordinary income the cost of raising a breeding animal and reporting as capital gain the resulting increase in profit on sale of the zero-basis animal. For example, if we assume that it costs $100 to raise a

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[6] Since opening inventory includes both breeding and beef cattle and since opening inventory is in effect deducted from income, those breeders which have been sold must be removed from opening inventory in order to avoid a double deduction: Once in computing the amount of capital gain and again in computing ordinary income. *Gibbs* v. *Commissioner*, 33 T.C. 27; *Little* v. *Commissioner*, 34 T.C. 156, affirmed, 294 F 2d 661 (C.A. 9).

breeder which is ultimately sold for $150 after it has outlived its breeding utility, an accrual basis rancher would have a capital gain of $50. A cash basis rancher, on the other hand, would deduct the $100 of raising costs against ordinary income as incurred and would then have a $150 capital gain upon sale. Thus the cash basis taxpayer (as compared to the accrual basis rancher) has $100 more capital gain and an equal offsetting deduction of $100 against ordinary income. Since a taxpayer can elect to be taxed on one-half of his capital gain income, the cash basis taxpayer obtains a $100 deduction in exchange for $50 of income.

The reason for this disparity in the treatment of breeding cattle is largely historical. The cash basis was designed to afford an extremely simple method of accounting to ranchers (and farmers) by obviating the necessity of maintaining any inventory procedure at all. Before ranchers were entitled to capital gains on the sale of breeding cattle, the cash method merely resulted in the deduction of the costs of raising cattle at the time the outlays were made rather than in the later year when the cattle were sold (as under the accrual method), but in any event only ordinary income was affected. However, when Congress in 1951 granted capital gain treatment on the sale of breeding cattle,[7] cash basis taxpayers automatically

[7] The possibility of ranchers obtaining capital gain treatment for profits on sales of breeding cattle first arose in 1942 with the enactment of the predecessor of present Code § 1231(a) providing for capital gain on sales of "property used in the trade or business" (§ 117(j) of the 1939 Code,

received an unintended tax advantage from the transformation of ordinary income into capital gain. Although the Commissioner wished, at this point, to amend the regulations to require cash basis ranchers to accumulate the costs of raising breeders, a study of the legislative history of the 1951 amendment convinced the Treasury Department that Congress had precluded such a basic change in the cash method of accounting. Both Committee Reports had stated that capital "gains from sales of livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and *presently* recognized by the Bureau of Internal Revenue." S. Rep. No. 781, 82d Cong., 1st Sess., p. 42; H. Rep. No. 586, 82d Cong., 1st Sess., p. 32 (emphasis added). Therefore, in 1952 the Secretary of the Treasury informed Congress that the new capital gain provision, when considered in conjunction with the Treasury Regulations governing methods of accounting, had created a "windfall" for cash basis taxpayers on the sale of breeding animals (Letter of June 27, 1952, from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, 98 Cong. Rec., Pt.

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added by § 151(b) of the Revenue Act of 1942, 56 Stat. 798). The first court of appeals decision upholding the claimed capital gain treatment for breeding cattle was in 1949 (*Albright* v. *United States*, 173 F. 2d 339 (C.A. 8)), and Congress amended the Code in 1951 to explicitly provide for capital gain treatment on breeders held 12 months or more. (Revenue Act of 1951, § 324, 65 Stat. 452; see generally *United States* v. *Ekberg*, 291 F. 2d 913, 916, fn. 5, 919-920 (C.A. 8), certiorari denied, 368 U.S. 920).

6, pp. 8307-8308, reprinted Catto R. 11-19). Although the Secretary's letter stated that legislation was necessary to eliminate this unwarranted benefit to cash basis taxpayers, Congress did not act. In fact, two years later when the 1954 Code was enacted, the provision for breeding cattle was retained verbatim (as Section 1231).

In short then, the accrual basis rancher is required by regulation to accumulate (*i.e.*, capitalize) the costs of raising breeding animals and, upon sale, report as capital gain only the excess of sales proceeds over cost basis. This is consistent with the tax treatment of capital assets in other types of profit-making enterprises. The cash basis rancher, on the other hand, receives an unwarranted tax windfall, because he deducts against ordinary income the full costs of raising breeding animals (thus giving him a zero cost basis in the breeders) and upon sale replaces this previous reduction in ordinary income with an equal amount of capital gain. While the Treasury Department has thus far been unsuccessful in closing this loophole for the cash basis rancher, it does not follow that an accrual basis rancher must be allowed the same windfall. The legislative history and statutory reenactment which prevent the Secretary of the Treasury from amending the regulations relating to cash basis ranchers also give the effect of law to the long-standing and explicit regulations requiring accrual basis ranchers to capitalize the costs of raising breeding cattle. *Brewster* v. *Gage*, 280 U.S. 327, 337; *Helvering* v. *Winmill*, 305 U.S. 79, 83; *Boehm* v. *Commissioner*, 326 U.S. 287, 291-292. Since

the accrual rancher has elected to capitalize the costs of raising his animals, it would be incongrous indeed to permit him to dispense with this practice as to his breeding herd while requiring him to maintain it as to his beef herd. See *Little* v. *Commissioner*, 294 F. 2d 661, 663-664 (C.A. 9). Nevertheless, that is exactly what the Fifth Circuit has done in the instant cases by holding invalid the Treasury Regulation requiring accrual basis ranchers to capitalize the costs of raising breeding animals.

3. A material revision in the method of treating raised breeding livestock is clearly a change in taxpayers' "method of accounting" and thus requires the "consent of the Secretary or his delegate." Internal Revenue Code of 1954, § 446(e), App. B, *infra*, p. 36; Treas. Reg. § 1.446-1(e)(2)(i), App. B, *infra*, pp. 40-41; *United States* v. *Ekberg*, 291 F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920; cf. *Carter* v. *Commissioner*, 257 F. 2d 595 (C.A. 5); *Irvine* v. *United States*, 212 F. Supp. 937 (D. Wyo.). None of the taxpayers in the instant cases had ever applied to the Commissioner for such a change in their method of accounting. Nevertheless, the Fifth Circuit held that the material revision in accounting for breeding cattle which these taxpayers asked the court to grant (and which the court did grant) did not constitute a "change in accounting method which necessitates the consent of the Commissioner . . ." and thus excused their failure to apply for permission to change.[8] *United States* v. *Catto*,

[8] The Commissioner has generally denied ranchers' requests to change from the accrual to the cash method of ac-

App. A, *infra*, p. 21.

Moreover, the court below permitted the taxpayers to take an immediate deduction for the full accumulated cost basis of all raised breeding animals on hand, although the court explicitly recognized that this would give them "an inordinate deduction against ordinary income in the year in which the correction is made." *United States* v. *Catto*, App. A, *infra*, p. 21. Under these decisions the taxpayers will thus be in the anomalous position of capitalizing the costs of all beef cattle and of purchased breeding cattle while taking an immediate deduction for the costs of raising breeding cattle. See *Carter* v. *Commissioner*, 257 F. 2d 595; *United States* v. *Wardlaw*, App. A, *infra*, pp. 24-25. The twofold effect of this hybrid method of accounting will be, first, to give the taxpayers an inordinately large deduction against ordinary income

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counting except for ranchers with very small herds. Where large herds are involved the accrual method provides a much clearer and more accurate reflection of income. Therefore, the Commissioner has denied requests where the only reason for the change was to obtain the tax windfall presently permitted to cash basis taxpayers and no valid business reason was demonstrated. This policy, we submit, does not constitute an abuse of the Commissioner's broad discretion to insure that taxpayers use methods of accounting that accurately reflect income. At all events, since none of the instant taxpayers applied to the Commissioner for permission to change to the cash basis, or made any attempt to show any business reason for the change, they are not in a position to challenge the Commissioner's actions in denying the requests of other taxpayers. Finally, the court's decisions did not put the taxpayers on the cash basis, but on an unprecedented hybrid method of accounting which does not clearly reflect their incomes.

in the year of the change, and thereafter to permit them to transform ordinary income into capital gain by using a zero basis in computing capital gains.

CONCLUSION

There is a clear conflict among the courts of appeals. The question, moreover, potentially affects large numbers of taxpayers and will have a substantial impact upon the revenue. Accordingly, we respectfully submit that this petition for certiorari should be granted.

THURGOOD MARSHALL,
Solicitor General.

JOHN B. JONES, JR.,
Acting Assistant Attorney General.

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Assistant to the Solicitor General.

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MARTIN T. GOLDBLUM,
Attorneys.

SEPTEMBER 1965

APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 21351

UNITED STATES OF AMERICA, APPELLANT

versus

JOHN CATTO, JR., and ROXANA CATTO, his wife,
APPELLEES

Appeal from the United States District Court for the Western District of Texas

(April 8, 1965.)

Before GEWIN and BELL, Circuit Judges, and MCRAE, District Judge.

PER CURIAM: This appeal raises once again the problem of the tax and accounting treatment to be accorded raised breeding cattle which are sold by an accrual basis taxpayer.[1] The appellees, who are owners and operators of two cattle ranches in West Texas, keep their books on the accrual basis and file their tax returns accordingly.

Taxpayers, in conformity with Treasury regulations,[2] have chosen to value their inventory by the

[1] The identical issue is raised in United States v. Wardlaw, No. 21607, ... F.2d . . . ., decided this day.

[2] Treas. Reg. 1.471-6(c).

unit-livestock-price method. If this method is used, standard unit values are assigned to different classes of animals within the herd, representing estimated rather than actual expenses of raising each animal, and standard increments are added to closing inventory each year. Under Treas. Reg. 1.471-6(f), a taxpayer who elects to use the unit-livestock-price method of valuing his inventory must apply it to all of his *raised* livestock, whether they are held for sale or for breeding purposes. Hence, an accrual taxpayer who employs the unit-livestock-price method must include his raised breeding cattle in inventory along with his cattle held for sale, although the breeding cattle may be taxed at capital gains rates upon sale.[3]

Prior to and during the taxable years in question, the taxpayers complied with Treas. Reg. 1.471-6(f). They removed the raised breeding cattle which they sold from opening and closing inventory for the year of sale and paid a capital gains tax on the sales, using the inventory value under the unit-livestock-price method as the basis for computing the gain on the sale of each animal.

Taxpayers then instituted this suit for refund in the district court, contending, on the basis of our decision in *Scofield* v. *Lewis*, (5 Cir. 1958) 251 F.2d 128, that Treas. Reg. 1.471-6(f) is invalid and that they may therefore correct the erroneous inclusion of raised breeding cattle in inventory by removing all such cattle from closing inventory. This procedure, in effect, affords them a deduction of the estimated raising costs against ordinary income, but they must compute the gain on the sale of these cattle on a zero basis. The net effect of this transaction is to substitute a deduction against ordinary income for

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[3] 26 U.S.C.A. § 1231(b)(3).

a deduction against capital gains. The district court, following *Scofield*, ruled in favor of the taxpayers.

The Government challenges the propriety of applying the *Scofield* rationale, urging that the requirement that raised breeding cattle be inventoried is merely a convenient means of capitalizing the cost of such cattle until the time of sale and, as such, is a valid exercise of the Commissioner's power to prescribe accounting methods which accurately reflect income. The taxpayers, on the other hand, note the discriminatory effect of this requirement on accrual taxpayers, since the Treasury has long indulged similar cash basis taxpayers by allowing them to write off the raising costs of breeding cattle against ordinary income and compute their capital gain on the sale of such cattle on a zero basis. They argue that *Scofield* was correct in holding that Treas. Reg. 1.471-6(f) is inconsistent with section 1231(b)(3), which accords all breeding cattle capital gains treatment. While we are fully cognizant of the anomaly of allowing such tax treatment of a capital asset and appreciate the appealing conceptual arguments of the Government, we regard *Scofield* as controlling until its legislative or judicial demise.[4]

Since *Scofield* governs on the issue of the invalidity of Treas. Reg. 1.471-6(f), we think the taxpayer is justified in correcting the error which the regula-

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[4] We are also aware of the fact that the two Circuits that have examined the problem since the *Scofield* decision have refused to follow it, see Little v. Commissioner (9 Cir. 1961) 294 F.2d 661; United States v. Ekberg (8 Cir. 1961) 291 F.2d 913, *cert. denied*, 368 U.S. 920, 7 L.Ed.2d 135, and that this Court has severly limited its applicability, see Carter v. Commissioner (5 Cir. 1958) 257 F.2d 595, which relates to purchased breeding animals inventoried on the farm-price method.

tion imposed by the procedure which he suggests, even though it results in an inordinate deduction against ordinary income in the year in which the correction is made. Moreover, we do not deem this a change in accounting method which necessitates the consent of the Commissioner, particularly in view of the consistent refusal of the Commissioner, during the years in question, to entertain applications by accrual basis cattle ranchers to change to the cash method of accounting for tax purposes.[5]

Accordingly, the judgment is AFFIRMED.

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[5] It was stipulated that during the years 1954-1958, the Commissioner refused to consider ranchers' requests to change from accrual accounting methods to the cash receipts and disbursements method. A similar situation obtained during the years 1946-1949, as indicated by *Scofield* v. *Lewis*, 251 F.2d at 131. The taxpayer, therefore, feels he cannot escape from the "Box" in which his election has placed him.

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

Before GEWIN and BELL, *Circuit Judges, and* MCRAE, District Judges.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

April 8, 1965

Issued as Mandate: May 3, 1965

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 21607

UNITED STATES OF AMERICA, APPELLANT-APPELLEE

versus

W. H. WARDLAW, Independent Executor of the Estate of C. H. Wardlaw, Deceased, ET AL, APPELLEES-APPELLANTS.

(AND REVERSE TITLE)

Appeals from the United States District Court for the Western District of Texas.

(April 8, 1965.)

Before MARIS,* RIVES and BROWN, Circuit Judges.

PER CURIAM: This appeal and cross appeal presents Taxpayer's and the Government's dissatisfaction with the trial Court's disposition of the tax refund suit. We affirm.

At issue is the proper income tax treatment of *raised* breeding animals and *purchased* breeding animals owned by an accrual basis Taxpayer-Rancher.

The Government's appeal concerns *raised* breeding

* Of the Third Circuit, sitting by designation.

animals.[1] The District Court followed our opinion in *Scofield* v. *Lewis*, 1958, 251 F.2d 128, which held that Treasury Regulation 1.471-6(f) was invalid. Despite the doubts generated by express rejection of *Lewis* by the 8th and 9th Circuits,[2] a somewhat restricted reading of it by us in *Carter* v. *Commissioner*, 5 Cir., 1958, 257 F.2d 595, and the impressive conceptual arguments perhaps not fully advanced earlier, we recognize that *Lewis* is directly in point and is, and must be, controlling until the principle is judicially reversed or legislatively repealed.[3]

The Taxpayer's appeal concerns *purchased* breeding animals. Accrual basis livestock farmers under Treas. Reg. 1.471-6(g) (1954 Code) are given an option to include in inventory their purchased breeding animals, or to treat them as capital assets subject to de-

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[1] The same issue is now pending before another panel of this Court in United States v. Catto, No. 21351, 1965, ... F.2d . . . . .

[2] United States v. Ekberg, 8 Cir., 1963, 291 F.2d 913; Banks v. Commissioner, 8 Cir., 1963, 322 F.2d 530, 546-47; Little v. Commissioner, 9 Cir., 1963, 294 F.2d 661; see also Irvine v. Commissioner, D.C. Wyo., 1963, 212 F.Supp. 937.

[3] Congress, at least since 1952, has been aware of many of these problems. See letter of June 27, 1952, from Secretary of the Treasury to Senator George, Chairman of the Senate Finance Committee, 98 Cong. Record, part 6, pp. 8307-8308. One complicating factor is the practice, recognized by formal regulations by which both accrual and cash basis taxpayers may deduct the cost of feeding, raising and maintaining animals as ordinary and necessary business expense rather than treating them as capital expenditure for the "acquuisition" of a capital asset, i.e., a mature animal. Treasury Regulation 1.162-12. This regulation, with only slight terminology changes, goes back to 1921. See, e.g., Regulation 45, Art. 110, for the year 1921; Reg. 101, Art. 23(a)-11, for the year 1936.

preciation. Taxpayer here, prior to 1957, had been including purchased animals in inventory, but, without the Commissioner's consent, elected in the years 1957, 1958, 1959 to exclude purchased animals from inventory so as to (a) depreciate their cost basis and (b) upon sale report capital gain against depreciated cost rather than inventory value. The District Court sustained the Commissioner's refusal to permit this.

The difference between Taxpayer and the Government is a narrow one. Taxpayers recognize that the option has to be exercised and that once exercised as to a particular animal, that animal cannot be changed from inventory to depreciable asset, or vice versa. The Government urges that it is the practice with respect to the herd. We agree.

The Regulations, § 1.61-4(b)[4] require a consistency from year to year and as such represent a valid exercise of the Commissioner's power to prescribe reasonable accounting methods. *Cf. Carter* v. *Commissioner*, 5 Cir., 1958, 257 F.2d 595. We are not impressed with Taxpayer's argument that it was 1960 before it was learned for the first time that only one election is afforded. The Regulation is plain and administratively reasonable. "There is no evidence that Ruling 60-60 departed from any prior construction of the applicable statutes and regulations." *Tee Bar Ranch Co.* v. *United States*, D. Mont., 1963, 63-2 USTC #9663, at 89,681 and authority there collected.

AFFIRMED.

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[4] § 1.61-4(b). "A farmer using accrual method of accounting must use inventories to determine his gross income * * *. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory * * * instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. * * *."

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

Before MARIS,* RIVES and BROWN, Circuit Judges.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

April 8, 1965

Issued as Mandate: May 3, 1965

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* Of the Third Circuit, sitting by designation.

IN THE

UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 16709

FRANK SCOFIELD, Collector of Internal Revenue, APPELLANT

versus

A. J. LEWIS and GRACE M. LEWIS, APPELLEES

Appeal from the United States District Court for the Western District of Texas

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(January 20, 1958.)

Before CAMERON, JONES and WISDOM, Circuit Judges.

JONES, Circuit Judge: The appellees, A. J. Lewis and Grace M. Lewis, husband and wife, were members of a partnership which conducted to ranching operations in West Texas. They will be called taxpayers in this opinion. For Federal income tax reporting the taxpayers were on a cash basis and the partnership was on an accrual basis. The partnership's operation was organized for the purpose of breeding high quality cattle and sheep. From year to year the partnership sold the steer calves and the mutton sheep produced by its breeding herd. It also sold, from time to time, from its breeding herd, when

required by age, disease, drought or other necessitous circumstance, some of its cows and ewes as well as some of the bulls and bucks, and heifers which were unfit for breeding stock or which could not, for some other reason, be retained. During the tax years here involved, 1946 through 1949, no animals were sold which had not been held for six months except baby calves which were, of necessity, sold with their mothers. Operating on an accrual basis, the partnership carried its livestock which it raised for the markets on an inventory basis and these animals were valued under the unit-livestock-price method. For 1939 and years subsequent, including the years 1946 through 1949 here involved, the breeding stock was carried on the inventory. This was done in compliance with the Commissioner's Regulation which provided that "A taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes." Under the unit-livestock-price method heifers were valued by the partnership at $40, yearlings at $45, two-year-olds at $50, and three-year-olds and over at $55, with the annual inventory increases treated as ordinary income. Ewe lambs were given similar treatment. The taxpayers returned their gains on the sales of breeding stock through 1949 as ordinary income.

In 1949 there appeared three tax decisions, *Albright* v. *United States*, 8th Cir. 1949, 173 F. 2d 339; *Emerson* v. *Commissioner*, 12 T. C. 875; and *Fawn Lake Ranch Co.* v. *Commissioner*, 12 T. C. 1139, appeal dismissed 180 F. 2d 749, each holding upon the particular facts of the case that sales of breeding herd animals were entitled to capital gains treatment for tax purposes. The taxpayers filed claims for refunds for the years 1946 through 1949 claiming the

difference between the tax they had paid on profits from sales of breeding stock at ordinary income rates and the amount they would have paid, by their computation, on a capital gains basis. Before the Commissioner had acted upon the claim for refund the pertinent provision of the applicable Revenue Act had been amended. Section 117 of the Act, 26 U.S.C.A. (I.R.C. 1939) § 117(j), excludes from capital gains tax treatment, among other things "property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year". In the Revenue Act of 1951, 65 Stat. 452, the following was included (at 501):

> "Section 117(j)(1) is hereby amended by adding at the end thereof the following new sentences: 'Such term [property used in the trade or business] also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.' The first sentence added to section 117(j)(1) by the amendment made by this section shall be applicable with respect to taxable years beginning after December 31, 1941, except that the extension of the holding period from 6 to 12 months shall be applicable only with respect to taxable years beginning after December 31, 1950. The second sentence added to section 117(j)(1) by the amendment made by this section shall be applicable only with respect to taxable years beginning after December 31, 1950."

The Regulations promulgated by the Commissioner contained the following provisions:

"Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided adjustments are made in accordance with one of the two methods outlined in (1) and (2) below. It is optional with the taxpayer which method is used, but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method be authorized by the Commissioner.

* * * *

"A taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner." Treas. Reg. 111, § 29.22 (c)-6, as amended by T. D. 5423, 1945 C. B. 70.

By another Regulation the Commissioner directed that "in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method." The same regulation requires that "A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner", and that "a change in the method of accounting means * * * a change from cash receipts to the accrual method, or vice versa", or a change involving

the basis of valuation employed in the computation of inventories. Treas. Reg. 111, § 29.41-2.

On May 19, 1953, following the amendment to Section 117(j), the Commissioner acted upon the refund claims, recognized that the sales of breeding stock were entitled to capital gains treatment, allowed the claims in part, disallowed them in part, and assessed tax deficiencies for 1946 and 1949. The taxpayers sued for the amount of their claim which had been disallowed. The district court held that the proceeds of baby calves sold with their mothers should be taxed as ordinary income and $10 of the price of the pair was allocated as the price of the calf. No question is before us with respect to the tax incidents of the sale of the calves. The district court resolved the other questions for the taxpayers and entered judgment against the Collector, from which judgment he has appealed. Before the district court it was claimed by the Government, as it is claimed before us, that the taxpayers were on a unit-livestock-price inventory accrual basis and that they could not, under the regulations, change from such basis to a cash basis and take the breeding stock out of the inventory without the consent of the Commissioner. Therefore, the Government says, the taxpayers are entitled to a capital gain measured by the difference between the accrued cost basis attributable to the breeding stock sold and the sales proceeds. The district court held that the taxpayers were entitled to a capital gain on the entire purchase price. In the court's findings of fact it was recited:

> "The uncontroverted evidence shows and the Court finds that (i) such approval [of a change in accounting methods and inventory practices] could not have been obtained for the years involved because they had already passed when the

> issue arose (following the Albright decision in 1949) and (ii) the Commissioner had refused to consider and approve any such application until his Bureau Release of May 12, 1953, and (iii) that plaintiffs in their claims for refund and in the administrative hearings were seeking the right to correct a mistake by simply removing a capital asset that, under the terms of Section 117(j) could not be the subject matter of an inventory, and which should never have been in the inventory in the first place."

The district court held that the portions of Regulations 29.22 (c) which require the inclusion of breeding stock in a ranch inventory were in conflict with Section 117(j) and hence invalid, and that no change of accounting method was involved and therefore neither the approval nor consent of the Commissioner is required. The sole issue we are to determine is whether the cost basis to be used in computing the capital gain on breeding stock sold is zero, as the taxpayers claim, or a basis accrued under the unit-livestock-price method of inventory valuation, for which the Government contends.

In 1944 the Commissioner ruled that the cost basis of stock of a breeding herd of a taxpayer on a cash receipts and disbursements basis had a zero cost on such livestock, but as to a taxpayer on an accrual basis the accrued inventory basis would be regarded as cost. By this ruling it was said that animals culled from a breeding herd as feeder or slaughter animals would not be treated as capital assets. I. T. 3666, 1944 C.B. 270. In the following year the Commissioner undertook to define animals "culled from the breeding herd" as including stock "which due to injury, age, disease or any other reasons (other than that of changing the breed or the quality of the offspring)

are no longer desired by the livestock raiser for breeding purposes, and also the normal selection for sale of animals for the purpose of maintaining the herd at a regular size." I.T. 3712, 1945 C.B. 176. Two years later, on August 4, 1947, the Commissioner wrote a member of the Senate that "culls" would include all animals sold in excess of the animals added to the herd as long as the herd was held at normal size, and sales of culls would give rise to ordinary income. 1948 C.C.H. Par. 6091.

The resentment of stock breeders and dairymen at the Commissioner's efforts to restrict their capital gains treatment found its first reported expression in *Albright* v. *United States, supra,* from the Eighth Circuit. The Tax Court soon followed with its decisions in *Emerson* v. *Commissioner, supra,* and *Fawn Lake Ranch Co.* v. *Commissioner, supra.* In the Fawn Lake case the taxpayer used the unit-livestock-price inventory accrual method. The Tax Court held that the taxpayer using an inventory basis was no less entitled to capital gains treatment than was a taxpayer on a cash basis as in the Albright case. The cost basis used in the Fawn Lake case was the accrued inventory figure which was what the taxpayer there had contended for. *Flato* v. *Commissioner,* 14 T. C. 1241, affirmed on other grounds 195 F. 2d 580, and *Kline* v. *Commissioner,* 15 T.C. 998, had only the factual questions of whether the particular sales were of breeding stock. In 1951, in a consolidation of five appeals, this court held that notwithstanding the I. T. rulings, stock breeders were entitled to capital gains treatment of animals culled from the herd where the usefulness of the animals had been lost and this regardless of the effect of the sales on the size of the herd. *United States* v. *Bennett,* 5th Cir. 1951, 186 F. 2d 407. We find no reported case on the question

which arose subsequent to the 1951 amendment to § 117(j).

The Government cites authority for the proposition that the Commissioner has power to prohibit the change of accounting methods by a taxpayer without the Commissioner's consent. *Ross B. Hammond, Inc.* v. *Commissioner*, 9th Cir. 1938, 97 F. 2d 545; *Jones* v. *Smith*, 10th Cir. 1951, 193 F. 2d 381; *Advertisers Exchange, Inc.* v. *Commissioner*, 25 T.C. 1086, affirmed 240 F. 2d 958. There are, though, other rules with respect to the effect of the Commissioner's Regulations. The Regulations must, by their terms and in their application, be in harmony with the statute. A Regulation which is in conflict with or restrictive of the statute is, to the extent of the conflict or restriction, invalid. A Regulation, valid when promulgated, becomes invalid upon the enactment of a statute in conflict with the Regulation. The only authority conferred, or which could be conferred, upon the Treasury Department is to make regulations to carry out the purposes of the statute. *Miller* v. *United States*, 294 U. S. 435, 55 S. Ct. 440, 79 L. Ed. 977, rehearing denied 294 U. S. 734, 55 S. Ct. 635, 79 L. Ed. 1262; *Newman* v. *Commissioner*, 5th Cir. 1935, 76 F. 2d 449, cert. den. 296 U. S. 600, 56 S. Ct. 116, 80 L. Ed. 425.

A taxpayer in the business of raising cattle who maintained breeding stock as well as a herd raised for sale could not, under the Regulations, elect to use the unit-livestock-price method of inventory values as to the herd raised for sale without using the same method as to the breeding animals and thus be required to use an accrued basis as cost upon making sales. As to a taxpayer who had commenced such procedure before the decision in the Albright case and those subsequent to it, the Commissioner insisted that

the unit-livestock-price inventory accruals be continued until his consent was given to a change, and at the same time refused to consider any applications to remove the breeding stock from the inventories. This, we think, was not what the Congress intended. We find nothing in the 1951 amendment to Section 117 (j), or for that matter in the Section as originally passed, indicating a Congressional design to limit the extent of capital gains treatment accorded to taxpayers selling animals from a breeding or dairy herd because of their prior election to use the unit-livestock-price method. The problem involves accounting practices and, to be sure, methods of accounting in some circumstances may be determinative of tax liability, but such is not the case here. Animals in a breeding herd are capital assets and no cogent reason appears why one group of taxpayers should be allowed the full benefits of the capital gains provisions by the use of a zero basis and others should be limited to a basis measured by the accrual under an inventory method which a regulation unreasonably required be used as to breeding stock if it was to be used as to animals raised for sale. The intent of the Congress, as we discern it, in the enactment of the 1951 amendment to Section 117(j) is otherwise. The amendment clearly and unequivocally says that livestock held for breeding purposes is property used in the trade or business of the taxpayer. As to such livestock the taxpayers were not required to include them in an inventory or to use a unit-livestock-price method to determine the cost basis of animals sold. *Cf. Schafer* v. *Helvering*, 299 U.S. 171, 57 S. Ct. 148, 81 L. Ed. 101.

We are in accord with the result reached by the District Court. Its judgment is

AFFIRMED.

APPENDIX B

Internal Revenue Code of 1954:

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * * *

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 1964 ed., Sec. 446.)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * *

(b) *Definition of Property Used in the Trade or Business.*—For purposes of this section—

* * * *

(3) *Livestock.*—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(26 U.S.C. 1964 ed., Sec. 1231.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.61-4 *Gross income of farmers.*

(a) *Farmers using the cash method of accounting.* A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the

year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). * * *

(b) *Farmers using an accrual method of accounting.* A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in sub-paragraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in sub-paragraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held

for draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471. * * *

* * * *

§ 1.162-12 *Expenses of farmers.*

* * * The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. * * * Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital, and shall be depreciated unless such animals are included in an inventory in accordance with § 1.61-4. * * *

* * * *

§ 1.167(a)-6 *Depreciation in special cases.*

* * * *

(b) *Depreciation in cases of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. See also section 162 and the regulations thereunder relating to trade or business expenses, section 165 and the regulations thereunder relating to losses of farmers, and section 175 and the regulations thereunder relating to soil or water conservation expenditures.

* * * *

§ 1.446-1 *General rule for methods of accounting.*

* * * *

(e) *Requirement respecting the adoption or change of accounting method.* * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from

which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

* * * *

§ 1.471-6 *Inventories of livestock raisers and other farmers.*

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied

to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent

taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market, whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the tax-

payer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

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No. 535

In the Supreme Court of the United States

OCTOBER TERM, 1965

UNITED STATES OF AMERICA, *Petitioner*

vs.

W. H. WARDLAW, *Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The District Court did not file an opinion. Its findings of fact and conclusions of law in **United States v. Wardlaw** (R.3-20) are reported at 223 F.Supp. 631. The opinion of the Court of Appeals (Pet. 23-25) is reported at 344 F.2d 225.

JURISDICTION

The judgment of the Court of Appeals was entered on April 8, 1965. (Pet. 22). The petition for a writ of certiorari was filed on September 3, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTION PRESENTED

Whether the livestock farmers in the **Wardlaw** case, having had to choose their method of accounting in years prior to 1944, and hence not having been afforded a "meaningful choice" under the rule of **United States v. Ekberg,** 291 F.2d 913, (C.C.A. 8th, 1961), and having been forced by Regulation 111, Sec. 29.22(c)-6 to use the unit-livestock-price method of valuing their inventories, can be compelled by the Commissioner to include their raised breeding animals in inventory, along with their livestock held for sale to customers in the ordinary course of business.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954
- Section 446(e) (26 U.S.C. Sec. 446)
- Section 1231 (26 USC Sec. 1231)
  (appearing at pp. 37 and 44, Appendix B, Pet.)

Treasury Regulation, Internal Revenue Code of 1954
- Section 1.61-4
- Section 1.162-12
- Section 1.167(a)-6(b)
- Section 1.446-1(e)(2)(i)
- Section 1.471-6
  (appearing at pp. 37 through 44, Appendix B. Pet.)

Treasury Regulation 111, Internal Revenue Code of 1939
- Section 29.22(a)-7
- Section 29.22(c)-6
  (appearing at p. 16, Appendix A. infra)

STATEMENT

The taxpayers in the **Wardlaw** case are ranchers engaged in the business of breeding and raising sheep,

goats and cattle for the production of wool, mohair, mutton and calves. When they commenced business,[1] which was from one to thirty years prior to the enactment in 1942 of Section 117(j) of the Internal Revenue Code of 1939,[2] and the promulgation of Regulation 111, Sec.29.22(c)-6[3], taxpayers adopted the accrual method of accounting and the constant unit price method of valuing their inventories. Section 29.22(c)-6 provided that a livestock raiser who, prior to 1944, had adopted the constant unit price method of valuing his livestock inventories, and who had filed returns on this basis, was considered as having elected the "unit-livestock-price method"; and, in addition, Sec.29.22(c)-6 provided that a taxpayer electing the unit-livestock-price method was required to include in his livestock inventory "all livestock raised, whether for sale or for draft, breeding, or dairy purposes." As a result of being thus compelled by this Section of the Regulations to include their raised breeding animals in inventory, the taxpayers in the **Wardlaw** case were forced to include in their **ordinary income** the initial inventory values of their raised breeding animals and thereafter the annual increases in inventory values assigned to such animals, including the tax years, 1957-1959, inclusive, here involved,[4] despite the fact that

---

1—One of the taxpayers commenced his ranching business prior to 1913, one in 1917, three in 1927, one in 1935, and one in 1941 (R. 7).

2—Sub-section (j) was added to Section 117 by the Revenue Act of 1942.

3—As amended by Treasury Decision 5423, 1945 Cum. Bull. 70, effective January 1, 1944, the present counterpart of which is Reg. 1.471-6.

4—This result is admitted by the Government (Stip. 25, R. 75), and the District Court found as a fact that the result of taxpayers being required by the Regulation to use the unit-livestock-price method and include raised breeding animals in inventory was that the initial inventory value of raised breeding animals put in inventory was taxed as ordinary income and all annual increases thereafter in inventory value of such raised breeding animals were also taxed as ordinary income. (Findings of Fact 11, R.11).

Section 117(j) and its successor, Section 1231, plainly provided that gain from the sale of "property used in the trade or business" should be taxed as capital gain, and despite the fact that the taxpayers had no "meaningful choice"[5] when they were required to select their accounting method, and had no choice at all as to whether or not they would use the unit-livestock-price method of valuing their inventories.

The District Court held that the selection of the accrual method of accounting and the unit-livestock price method of valuing inventory, by the taxpayers in the **Wardlaw** case, when they commenced operating their ranches, was not a meaningful choice inasmuch as the statute then did not authorize capital gains treatment on the sale of livestock used for breeding purposes.[6] (R.18). The District Court also held that, under these circumstances, the Regulation requiring the inclusion of raised breeding animals in inventory was invalid as to the livestock farmers before the Court, and that the requirement that raised breeding animals be included in inventory was in conflict with Section 1231 of the Internal Revenue Code. (R.16-17).

The District Court further found that the removal of livestock thus improperly forced into inventory did not involve a change of accounting method and that

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5—As pointed out in the **Ekberg** case, a "meaningful choice" as to accounting methods and as to methods of valuing inventory was not possible until 1944, when it first became apparent, by reason of the issuance of I.T.3666, 1944CB270, that capital gain was available on the sale of raised breeding animals, provided the rancher did not adopt the accrual method of accounting and the unit-livestock-price method of valuing his inventories.

6—Actually, the taxpayers in the **Wardlaw** case selected a constant unit price method of valuing their inventory when they commenced business, but as noted above, Reg. 111, Sec. 29.22(c)-6 required that taxpayers using a constant unit price method prior to 1944 were forced to elect and use the unit-livestock-price method for years after 1944. Obviously, the selection of a constant unit price method was not a meaningful choice, because at the time of the selection (long prior to 1944) capital gains treatment for the sale of breeding stock was not authorized.

hence neither the approval nor the consent of the Commissioner was required to remove the livestock from inventory. (R.17). It was stipulated that the Commissioner, during the years in question, had consistently refused to entertain applications by accrual-method livestock farmers to change to the cash method of accounting until the final regulations under Section 481 of the Internal Revenue Code of 1954 were issued, which was on February 19, 1959. (R.81). See also Pet., Appendix A, Page 21.

The Court of Appeals for the Fifth Circuit, noting that the District Court had followed the opinion in **Scofield v. Lewis,** 251 F.2d 128, (C.C.A. 5th, 1958), and recognizing that such opinion was directly in point and was controlling, affirmed the judgment of the District Court with respect to the raised breeding animals.

REASONS FOR DENYING THE WRIT

(1) There is **no conflict** between the decisions in **Wardlaw** and **Lewis** on the one hand and **Ekberg** on the other hand, as petitioner contends. In 1961, petitioner **opposed** the petition for a writ of certiorari filed with this Court by the taxpayer in the **Ekberg** case on the ground that

> "The decision of the Court of Appeals for the Fifth Circuit in **Scofield v. Lewis** . . . , with which the petitioner asserts a conflict, is . . . distinguishable . . . Further review of the issue by this Court is unnecessary." See **Ekberg,** Brief for the United States in Opposition, p. 4

Now, four years later, petitioner says the decision of the Court of Appeals for the Fifth Circuit in the instant **Wardlaw** case is in "direct conflict" with the decision in **Ekberg.** (Pet. p. 5).[6a] This is equivalent to saying that

6a—**Carter v. Comm.,** 257 F. 2d 595, cited by petitioner, is not in point: It did not involve the same Regulation section now in question, and it did not involve raised breeding animals.

the decision in **Lewis** is in direct conflict with **Ekberg**, because the Government has never questioned the fact that the **Lewis** case and the **Wardlaw** case are identical, and the District Court and Circuit Court of Appeals have so held.

Petitioner's inconsistency is, of course, due to the fact that he won the **Ekberg** case but lost the **Wardlaw** case. However, since this Court denied the petition for a writ in the **Ekberg** case, recognizing that **Lewis** and **Ekberg** were, as the Government contended, "distinguishable", there is no reason to expect this Court to reverse its position now.

Clearly the decisions in **Wardlaw** and **Lewis** are distinguishable from the decision in **Ekberg**. The distinction lies in the very important fact that when the taxpayers in the **Lewis** and **Wardlaw** cases had their chance to choose between the cash method of accounting and the accrual method, and to select a method of valuing their inventories, which chance came when they began business prior to 1944,[7] it was not recognized that a farmer could get capital gain treatment on the sale of his breeding animals under any circumstances, regardless of what method of accounting or what method of valuation he adopted; whereas, when the taxpayer in the **Ekberg** case had his chance to choose his method of accounting and his method of valuation, which chance came when he began business in 1947, it was clearly recognized that a farmer could get capital gain treatment on the sale of his breeding animals, provided he did not adopt the accrual method of accounting and elect the unit-livestock-price method of valuing his inventory.[8] Thus the taxpayer in the **Ekberg**

7—The taxpayer in **Lewis** began business in 1939; in **Wardlaw**, the taxpayers began business in various years from prior to 1913 to 1941. See footnote 1, supra.

8—By reason of I.T. 3666 and Sec. 29.22(c)-6 of Reg. 111, as amended by T.D. 5423, both of which were published in 1944.

case had a "considered and meaningful choice"[9] when he selected his accounting method and his method of valuing his inventory, because at the time he made his selection the consequences of the available options were known. The taxpayers in the **Lewis** and **Wardlaw** cases, on the other hand, did not have a meaningful choice because when they had to make their selection, long prior to 1944, the consequences of the available options were not known; in fact, prior to the issuance of I.T.3666 in 1944 there was no indication that livestock farmers could get capital gain treatment on the sale of their breeding animals regardless of **what** methods of accounting or methods of valuation they might use.

The **Ekberg** case held that the critical date, before which choices of accounting method and valuation method were not meaningful, and after which such choices were meaningful, was 1944, the year in which the Internal Revenue Service issued I.T.3666, which recognized for the first time that, under Section 117(j) of the Internal Revenue Code, capital gain treatment was available on the sale of breeding animals, provided certain requirements were satisfied. In the same year, 1944, the Regulations established the farm price method and the unit-livestock-price method of valuing inventories. If a farmer elected to use the unit-livestock-price method of valuing his inventory, he was required to include his raised breeding animals in inventory.[10] In the **Ekberg** case, the taxpayer elected to use the unit-livestock-price method, and at the time he did so he knew that it required him to include his raised breeding animals in inventory; he was not re-

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9—**United States v. Ekberg.** supra, at page 924.

10—Farmers using the farm-price method of valuing inventories, or the lower of cost or market method, were not required to include their raised breeding animals in inventory.

quired to elect the unit-livestock-price method, but did so knowing its consequences, and the Court in the **Ekberg** case found that his choice was therefore "considered and meaningful" and he was therefore bound by it. In the **Wardlaw** and **Lewis** cases, on the other hand, the taxpayers never had a choice as to whether they would or would not use the unit-livestock-price method of valuation, because the 1944 Regulations provided that farmers who had, for taxable years prior to 1944, adopted a constant unit price method of valuing livestock inventories, and had filed returns on that basis, would be **considered as having elected** the unit-livestock-price method.[11] Since the taxpayers in the **Wardlaw** case had adopted the constant unit price method prior to 1944, and had filed returns on that basis prior to 1944, and the taxpayer in the **Lewis** case had done likewise, they were both **compelled** by the 1944 Regulations to use the unit-livestock-price method and hence **required** to put their raised breeding animals in inventory.

The Government in its brief opposing the petition for a writ in the **Ekberg** case, on the ground that there was no conflict with the **Lewis** case, points out (at p.7) this fundamental distinction between the **Lewis** and **Ekberg** decisions in the following language:

> "In **Scofield v. Lewis,** the Fifth Circuit . . . emphasized its belief that the taxpayer there elected to use the unit-livestock-price method, and thereby subjected his breeding herd to valuation by the same method, before it was known that the gain upon the sale of a breeding herd could be treated as capital gain rather than ordinary income. It should be noted that the taxpayer in **Lewis** had

11—Reg. 111, Sec. 29.22(c)-6, as amended by T.D.5423: "A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis, will be considered as having elected the 'unit-livestock-price method'."

carried his breeding herd in inventory since 1939. On the other hand, in the instant case, the taxpayer has been engaged in the business of raising Angus cattle only since 1947 . . . , and the Court of Appeals pointed out . . . that, in 1944, the Internal Revenue Service issued I. T. 3666, 1944 Cum. Bull. 270, recognizing that capital gains treatment was available upon the disposition of breeding cattle if all other necessary elements were satisfied. Therefore, the taxpayer here, unlike the taxpayer in the **Lewis** case, did have a meaningful option with respect to his accounting method when he went into business in 1947."

(2) In the **Wardlaw** case, Regulation 1.471-6(g) was held invalid as to the taxpayers there before the Court because they **were not** afforded a meaningful choice at the time they had to select their accounting method, and were afforded no choice at all as to the method they would use in valuing their inventory (being forced to use the unit-livestock-price method). In **Ekberg,** the Regulation in question was held valid as to the taxpayer before the Court, because the taxpayer there **was** afforded a meaningful choice, both as to accounting method and as to valuation method.

Petitioner discusses at some length this Regulation 1.471-6(g), which requires accrual-method farmers using the unit-livestock-price method to include their raised breeding animals in inventory along with animals held for sale to customers in the ordinary course of business. (Pet. pp. 6-15). Throughout the discussion, petitioner emphasizes that the farmer is given a **choice** between the cash method of accounting and the accrual method (Pet. p. 7), and that "the Regulations permit (but do not require)" the farmer to elect the unit-livestock-price method. (Pet.p.8). **However, the petitioner then proceeds to ignore completely the fact that the taxpayers in the Wardlaw case did not have a meaning-**

ful choice when they were required to choose their method of accounting, and had no choice at all as to whether they would use the unit-livestock-price method of valuing inventory.[12] As we have seen, they were **required** to use the unit-livestock-price method because they had previously used a constant unit price method; and when they chose this constant unit price method, long prior to the publication of I.T. 3666 in 1944, it was obviously not a meaningful or knowledgeable choice because they had no way of knowing, prior to 1944, that such choice would eventually force them, because of Sec. 29.22(c)-6, to use the unit-livestock-price method, which would in turn deprive them of full capital gains treatment for their raised breeding animals, a treatment which was completely unknown prior to the issuance of I.T. 3666 in 1944. Under these circumstances, it is submitted that petitioner's discussion of the Regulations has no relevance as far as the taxpayers in the **Wardlaw** case are concerned.[13]

12—For a choice to be meaningful, the person entitled to choose must have knowledge of the consequences of available alternatives. See **Ekberg, supra.** Petitioner admits that this is true. See Appendix B, infra. Petitioner also has admitted that the taxpayer in **Lewis** did **not** have a "meaningful option", and has pointed out that the reason for this was that the taxpayer in **Lewis** began business prior to 1944, which was the first year he could have made a meaningful choice. See quotation, page 9, supra, from Government's brief opposing writ in **Ekberg** case; see also Appendix B, infra. It follows obviously that the taxpayers in the **Wardlaw** case had no meaningful choice, since six of them began business in 1935 or earlier, and one in 1941.

13—It is very important to note here that the petition filed in this case seeks to cover both the **Wardlaw** case and another case, **United States of America, Petitioner** v. **John Catto, Jr. and Roxana Catto.** The petition states that the pertinent facts in both cases are substantially the same (Pet. p. 3.). This is not true. The truth is that there is a vital distinction between the two cases, which were argued at different times and before different panels of the Fifth Circuit Court of Appeals. The vital distinction lies in the fact that in the **Catto** case the Government argued that the taxpayers there had a meaningful choice "in 1948 and 1951, when they embarked on their proprietorships" and selected the accrual method of accounting and the unit-livestock-price method of valuing inventory, and on this ground the Government sought to distinguish **Catto** from **Lewis.** See Appendix B of this Brief. In the **Wardlaw** case, however, the Government did not contend that the taxpayers had a meaningful choice, either

(3) The livestock farmer using the cash method of accounting receives very fair treatment from the Commissioner in the handling of his raised breeding animals: He is permitted to deduct the cost of raising these animals, and when he sells the animals at the end of their useful lives he is permitted to treat the entire proceeds from the sale as capital gain, his basis being zero. This treatment follows normally from Section 117(j), which provided that gain from the sale of "property used in the trade or business . . . which is subject to the allowance for depreciation" should be taxed as capital gain; and from the recognition by I.T. 3666 that breeding animals constituted property used in the trade or business; and from the 1951 amendment to Section 117(j), made retroactive to 1942, which stated explicitly that the term "property used in the trade or business" included "livestock . . . held . . . for . . . breeding . . . purposes . . ."; and from the 44-year old Regulation, now Reg. 1.162-12, permitting farmers to take a current expense deduction for the costs of raising livestock held for breeding purposes.[14]

The Commissioner, however, was not in sympathy with the idea that livestock farmers should be permitted an ordinary deduction for the cost of raising breeding animals, and then get capital gain treatment

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as to accounting method or method of valuing inventory, because it was perfectly obvious that the taxpayers in the **Wardlaw** case, having started business long before the publication of I.T. 3666, had no meaningful choice as to accounting method, and had no choice at all as to whether or not they would use the unit-livestock-price method of valuation.

14—Currently, the right to deduct the cost of feeding and raising livestock is granted by Reg. 1.162-12. The right was granted in 1921 by Reg. 45, Art. 110. In a letter to Senator George from the Secretary of the Treasury in 1952 it was stated that ". . . since the early days of the income tax. the regulations have permitted farmers to take current expense deductions for the cost of raising livestock intended for . . . breeding . . . purposes." See Appendix B of the Government's Brief in the Court of Appeals, at p. 35. **The deduction is granted to all livestock farmers, regardless of whether they are on the cash or accrual method of accounting and regardless of what method of valuation they use.**

when the breeding animals were sold. Consequently, the Commissioner conceived the idea of **compelling** the accrual-method farmer using the unit-livestock-price method of valuing his inventory to include his breeding animals in his inventory along with his animals held for sale to customers in the ordinary course of business, thereby offsetting the raising costs deduction to which the farmer was entitled and, as we shall see, effectively blocking any capital gains treatment when the breeding animals were sold. The accrual method farmer was thus the unwilling victim of what the Court of Appeals in **Ekberg** called "the Commissioner's continuing reluctance to give full application of the statute [Sec. 1231] to breeding stock. . . .". **Ekberg**, p. 923, matter in brackets added.

Briefly, the accrual-method farmer using the unit-livestock-price method of valuation is treated as follows:

(a) The farmer is permitted to deduct the cost of raising his livestock held for breeding purposes. The right to deduct raising costs (i.e., shelter, food, medicine and other normal maintenance costs) has been specifically granted by the Regulations for over 44 years.

(b) The Commissioner offsets the benefit of the expense deduction granted for raising costs by requiring that raised breeding animals must be put in the farmer's inventory, at birth, at an estimated opening value, along with his animals held for sale in the ordinary course of business, and that the amount of the estimated annual increase in the value of the breeding animals should appear as an annual increase in inventory. The estimated annual increase would be equal to, or greater than, the farmer's actual annual raising costs. Adding opening value to inventory, and

increasing inventory by annual increments in value, of course creates ordinary income, and thereby effectively offsets the deduction for raising costs.

(c) This process of granting the expense deduction with one hand and taking it away with the other continues until the animal reaches maturity, at which time the accumulated inventory value for the animal has reached its peak. Generally, the breeding animal is then kept during its useful life as a breeder, and thereafter sold. The sale price (particularly of sheep and goats) rarely exceeds the value at which the animal last appeared in inventory, and frequently is less than inventory value. Consequently, the capital gain treatment prescribed by Congress is defeated, simply by eliminating the element of gain. Instead, by the device of forcing raised breeding animals into inventory, along with animals held for sale in the ordinary course of business, the Commissioner not only has effectively defeated his own 44-year old Regulation expressly granting an ordinary deduction for raising costs, but has converted into ordinary income what would otherwise, if the farmer were on a cash basis, be taxed as capital gain.[15]

It is plain that in the instant case the Regulation requiring that raised breeding animals be put in inventory along with animals held for sale to customers in the ordinary course of business frustrates the will of Congress: (a) Certainly Congress did not intend this gross discrimination against an accrual basis farmer forced to use the unit-livestock-price method, as com-

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15—A raised breeding animal is depreciable, being an asset used in the trade or business but not held for sale to customers in the ordinary course of business; but there is nothing to depreciate, since it cost nothing to acquire the animal at birth, and the raising costs thereafter incurred are merely maintenance costs which are specifically deductible under Reg. 1.162-12, and predecessor Regulations going back to 1921. Petitioner admits that depreciation is not available. (Pet. p. 10, footnote 5.).

pared with the cash method farmer. (b) Certainly Congress did not intend that animals which it had specifically characterized as "property used in the trade or business" should be forced into inventory along with animals held for sale to customers in the ordinary course of business; assets held for sale belong in inventory, whereas property used in the trade or business does not. (c) Certainly Congress did not intend that the 44-year old Regulation expressly giving livestock farmers the right to deduct the costs of raising animals held for breeding purposes should be defeated by a device forcing obviously non-inventory assets into inventory, and thereby creating false ordinary income.[16]

(4) Finally, it is apparent from the foregoing that the point here involved is extremely narrow[17], not of widespread interest or application, and for that reason alone would not appear to warrant review by this Court.

16—If the Commissioner wishes to oppose the deduction of costs of raising breeding animals as an ordinary expense, and insist that such costs be capitalized, then he ought to ask for legislation so holding, and not adopt a dubious Regulation designed to trap the accrual-method farmer, while surrendering completely to the cash-method farmer. Congress, so far, has taken the clear and unmistakable position that farmers should receive capital gain on the disposition of their breeding animals; and, by a Regulation of 44 years standing, the cost of raising breeding animals is a deductible expense, not to be denied by forcing breeding animals into inventory, where, as assets used in the trade or business, they obviously do not belong, or by otherwise seeking to compel a capitalization of such expenses.

17—Since the **Wardlaw** and **Lewis** cases are not in conflict with **Ekberg**, it may well be that the only point of difference in the decisions in any of these cases, including the **Catto** case, is that **Ekberg** used 1944 as the date after which all choices were "meaningful", whereas the **Catto** decision used 1951. The case of **Little v. Commissioner**, 294 F. 2d 61, (C.C.A. 9th, 1961), cited by petitioner as being in accord with **Ekberg** and in conflict with **Lewis**, apparently used 1942. All of the taxpayers in the **Wardlaw** case began business prior to 1942.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari in the **Wardlaw** case should be denied.

Respectfully submitted,

CLAIBORNE B. GREGORY

ELWOOD CLUCK
Attorneys

September 30, 1965

CERTIFICATE OF SERVICE

It is hereby certified that service of this Brief has been made on opposing counsel by depositing five (5) copies thereof in the United States Mail (Air Mail) with postage prepaid, addressed to THURGOOD MARSHALL, Solicitor General of the United States, Department of Justice, Washington, D.C., 20530, and by depositing one (1) copy thereof in the United States Mail with postage prepaid, properly addressed to ERNEST MORGAN, United States Attorney for the Western District of Texas, Federal Bldg., San Antonio, Texas, on this the 1st day of October 1965.

ELWOOD CLUCK

Attorney for W. H. Wardlaw,
Independent Executor of the Estate
of Crawford W. Wardlaw,
Deceased, et al, Respondents

APPENDIX A

Reg. 111, Sec. 29.22(a)-7. Gross income of farmers. —A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of livestock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which were purchased after February 28, 1913, is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income.

In the case of a farmer reporting on the accrual basis (in which an inventory is used to determine profits), his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the cost of live stock and products purchased during the year. In such cases all live stock

raised or purchased for sale shall be included in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Also live stock acquired, for draft, breeding, or dairy purposes and not for sale, may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. (See section 29.22(c)-6.

Reg. 111, Sec. 29.22(c)-6 (As amended by T. D. 5423, Dec. 15, 1944). Inventories of livestock raisers and other farmers. * * *

Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory basis may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in section 29.41-2.

The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuating his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: calves, $15; yearlings, $22.50; two-year old, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the Commissioner upon examination of the taxpayer's return.

A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for breeding, dairy, or draft purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased

at the end of each accounting year in accordance with the established unit prices, except that no increase is to be made in the year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in first-out method of valuing inventories must be applied.

If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in section 29.41-2. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock for taxable years beginning after December 31, 1943 without formal application for permission, but the classifications and unit prices selected are subject to approval by the Commissioner upon examination of the taxpayer's return. A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

* * *

APPENDIX B

The Government described the nature of a "meaningful choice" as to methods of accounting, and pointed out why the taxpayers in the **Catto** case had a meaningful choice, as follows (page 14, footnote 5, Brief for the Appellant, in the Court of Appeals below):

> "A choice between using the accrual and cash methods of reporting became 'meaningful' as early as 1942, certainly by 1944, when it became clear that breeding cattle could be given capital gain treatment and that cash basis taxpayers were permitted to expense their raising costs against ordinary income. See I.T.3666, 1944 Cum.Bull.270, 271-272. Thus, any taxpayer who chose the accrual method of accounting after 1942 (or 1944) presumably knew that he was being denied this special advantage accorded cash-basis taxpayers.
>
> "The taxpayers here selected the accrual method in 1948 and 1951, when they embarked on their proprietorships. Thus their choice was meaningful, contrary to the lower court's finding (R.48) that 'Plaintiffs did not have a knowledgeable choice as to accounting methods when they began operating their ranch as sole proprietorships in [1948 and 1951] ***.'"

The Government then stated that the selection of the unit-livestock-price method of valuing inventory, by the taxpayers in the **Catto** case, was meaningful, and that on this ground **Catto** could be distinguished from **Lewis** (page 18, including footnote 9, Brief for the Appellant, in the Court of Appeals):

> ". . . the taxpayers here [are] bound by their election to [inventory their breeding cattle] since they knowingly . . . elected to inventory their breeders

when they chose the unit-livestock-price method of inventorying their cattle."[9] (Matter in brackets added).

* * *

"9—The meaningfulness of their election can be said to distinguish this case from **Scofield v. Lewis, supra.** As noted above, in **Lewis** the taxpayer bound himself to the accrual system, using the unit-livestock-price inventory method **before** breeding animals began to receive capital gains treatment."

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, PETITIONER

v.

JOHN CATTO, JR. AND ROXANA CATTO

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE FIFTH COURT

BRIEF FOR
JOHN CATTO, JR. AND ROXANA CATTO
IN OPPOSITION

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BRIEF FOR
JOHN CATTO, JR. AND ROXANA CATTO
IN OPPOSITION

JOHN CATTO and ROXANA CATTO pray that the petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in the case of **United States v. John Catto, Jr. and Roxana Catto,** No. 21351, be denied; and respectfully represent:

OPINIONS BELOW

The District Court did not file an opinion. Its findings of facts and conclusions of law in **United States v.**

Catto (R. 38-41)[1], are reported at 223 F. Supp. 663. The **per curiam** opinion of the Court of Appeals (Pet. 18-21) is reported at 344 F.2d 227.

JURISDICTION

The judgment of the Court of Appeals was entered on April 8, 1965 (Pet. 22). The petition for a Writ of Certiorari was filed on September 3, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 1231 of the Internal Revenue Code of 1954, which permits capital gain treatment on property used in the trade or business, provides that livestock, regardless of age held by the taxpayer for draft, breeding, or dairy purposes and held for more than 12 months, are property used in the trade or business which is subject to the allowance for depreciation and is not properly includable in inventory. Treasury Regulation §1.471-6(f) on the other hand provides in part that a taxpayer who uses the "unit-livestock-price method" of valuing inventory must include all livestock raised whether for sale or for draft, breeding or dairy purposes, in inventory. The questions present are:

(1) Whether Treasury Regulation §1.471-6(f), requiring taxpayers to include raised livestock held for draft, breeding or dairy purposes in inventory, is contradictory to the provisions of Section 1231 of the Internal Revenue Code of 1954 and invalid and of no force and effect?

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[1] "R" references are to the printed records in the Court of Appeals.

(2) Whether, the taxpayers, without the consent of the Commissioner of Internal Revenue and in order to correct an error caused by the Commissioner's own regulation, are entitled to remove from inventory raised breeding livestock erroneously included in inventory in compliance with the Treasury Regulation?

STATUTES AND REGULATIONS INVOLVED

The applicable portions of Section 1231 and Section 446 of the Internal Revenue Code of 1954 and Sections 1.446.1 and 1.471.6 of Treasury Regulations on Income Tax (1954 Code), appear in the Appendix, **infra**, pp. 12 - 20.

STATEMENT OF THE CASE

Taxpayers are ranchers who raise cattle for sale. (R. 39). For that purpose they constantly maintain a breeding herd of cattle, to which is added purchased bulls and cows and selected calves raised by their breeding herd. (R. 40).

Since 1938 and during the years in issue the taxpayers kept books and filed income tax returns using the accrual (inventory) method of accounting and used the unit-livestock-price method of valuing inventory. (R. 40-41). In accordance with Treas. Reg. §1.471-6(f) (and its predecessors) taxpayers included raised breeding cattle held for sale in inventory at a unit value and increased the unit values as such cattle advanced in age (R. 41).

The inclusion of these animals in inventory resulted in increasing the taxpayer's ordinary income in the amount of the unit value or the increase in unit value in the year included and increased. If taxpayers were sub-

ject to tax in that year, it resulted in increasing ordinary income tax paid by them. On the other hand, it reduced the amount of income from the sale of cattle that was entitled to capital gain treatment because the taxpayers were required to deduct the accrued inventory value from the sale price in order to compute the amount of profit to which the capital gain rate would apply. (R. 42).

The Commissioner of Internal Revenue has not and does not require ranchers who maintain breeding herds and report their income on the cash receipts and disbursements basis to include raised breeding animals in inventory. (R. 42). Thus, such taxpayers enjoy the advantage of deducting the cost of raising breeding cattle against ordinary income and computing their capital gain on the sale of such cattle on a zero basis.

During the years in question taxpayers did not file a request to change from the accrual (inventory) method of accounting to the cash receipts and disbursements method as during such period the Commissioner refused to consider such requests. (R. 44).

After the Fifth Circuit's decision in **Scofield v. Lewis,** 251 F.2d 128, the taxpayers filed a timely claim for refund for the years in question claiming that Treas. Reg. §1.471-6(f) was contradictory to Section 1231 of the Internal Revenue Code of 1954, and, therefore, invalid and of no force and effect; and that they were entitled to correct the error caused by the Regulation. (R. 43-45). Said claim was neither rejected nor paid and after the expiration of six months taxpayers sued for a refund and the District Court rendered judgment in their favor (R. 44, 50). The Fifth Circuit affirmed **per curiam** on the authority of its earlier decision in **Scofield v. Lewis, supra,**

and held the Treasury Regulation requiring an accrual basis rancher using the unit-livestock-price method to include raised breeding cattle in inventory invalid. (Pet. 20-21).

ARGUMENT

The decisions of the Court of Appeals for the Eighth and Ninth Circuits in **United States v. Ekberg**, 291 F.2d 913 (C.A. 8), certiorari denied, 368 U.S. 920, and **Little v. Commissioner**, 294 F.2d 661 (C.A. 9), with which the petitioner asserts a conflict, are distinguishable from the the Fifth Circuit's decision in the instant case and **Scofield v. Lewis, supra.** Further review of the issue by this Court is unnecessary.

1. The Treasury Regulation Contravenes the Statute and is Invalid

The essential question here is whether the Commissioner of Internal Revenue can by Regulation rise above the statute. The statute plainly and unambiguously states that breeding herd livestock, regardless of age, held for more than 12 months are property used in the trade or business subject to the allowance for depreciation and not properly includable in inventory. Treasury Regulation §1.471-6(f), however, requires a taxpayer who uses the unit-livestock-price method in valuing inventory to apply it to all livestock raised, whether raised for sale in the ordinary course of business or for inclusion in the breeding herd.[2] Thus, the Regulation compels such a taxpayer to include raised breeding livestock in inventory.

[2] This identical regulation was in force for many years prior to the amendment of Section 117(j) of the Internal Revenue Code of 1939 (Revenue Act of 1951, §324, 65 Stat. 452), in 1951, specifically authorizing capital gain treatment for profits on the sale of breeding cattle. See Treas. Reg. 118, §39.22(c)-6(f), and Treas. Reg. 111, §29.22(c)-6.

The net effect of the Regulation in question is to discriminate against the accrual basis rancher who uses the unit-livestock-price method to value his inventory. He is required to include raised breeding livestock in inventory at a unit value, thereby increasing his ordinary income and tax thereon. When he sells such animals he must deduct the accrued unit value from the proceeds of the sale. A rancher who uses the cash receipts and disbursements method, on the other hand, is not required to include such animals in inventory and pay ordinary income tax thereon, and when such animals are sold he receives capital gain treatment on the entire proceeds. Thus, the Regulation discriminates against the accrual basis rancher, contrary to the clear intent of Congress that the statute was a relief provision applicable alike to all taxpayers within its provisions. **Albright** v. **United States,** 173 F.2d 339, 343 (C.A. 8); H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 53-54; and S. Rep. No. 1631, 77th Con., 2d Sess., p. 50.[3]

The discriminatory effect of the Regulation was brought to the attention of the courts in **Scofield v. Lewis, supra.** The Court of Appeals for the Fifth Circuit held

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[3] From the original enactment of Section 117(j) of the Internal Revenue Code of 1939 [Revenue Act of 1942, §151(b), 56 Stat. 798], until its amendment in 1951 (Revenue Act of 1951, §324, 65 Stat. 452) at which time it was made specifically applicable to livestock, the Commissioner attempted to limit and deny the benefits of the section to the livestock industry. See I.T. 3666, 1944 C.B. 270; I.T. 3712, 1945 C.B. 176; Letter of Commissioner, Aug. 4, 1947, as cited in **Albright** v. **United States,** 173 F.2d 339, 343 (C.A. 8); and Minn. 6660, 1951-2 C.B. 60. However, the Courts uniformly struck down the Commissioner's unfounded attempts to withhold from breeding herd owners the capital gain treatment afforded by Section 117(j). **Albright v. United States, supra; United States v. Bennett,** 186 F.2d 407. (C.A. 5); **Mitchell** v. **United States,** 96 F. Supp. 473 (N.D. Col.); **Miller** v. **United States,** 98 F. Supp. 948 (D. Neb.); **Colvert v. United States,** 101 F.Supp. 675 (E.D. Okla); **Emerson** v. **Commissioner,** 12 T.C. 875; and **Fawn Lake Ranch** v. **Commissioner,** 12 T.C. 1139..

that the Regulation was in conflict with the statute. As to a taxpayer like Lewis, who had elected the unit-livestock-price method, and was thereby compelled to include raised breeding livestock in inventory before it was known that gain upon the sale of breeding herd livestock could be treated as capital gain, the Regulation was invalid.

The Court of Appeals for the Eighth and Ninth Circuits then followed with the decisions in **Ekberg** and **Little.** While these Courts reached a different result, the facts were significantly different and clearly distinguishable. In each instance the taxpayer made his election when he knew, or should have known, the advantages and disadvantages of the unit-livestock-price method. Therefore, those taxpayers had a meaningful option with respect to their accounting method. While the Government fails to recognize this distinction in its Petition in this case, this was the principal ground upon which certiorari was opposed by the Government in the **Ekberg** case. (Br. Op. No. 415, Oct. Term, 1961, p. 7).[4]

Likewise, the Fifth Circuit's decision in **Carter v.**

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[4] In opposing certiorari in Ekberg, the Solicitor General said:
"In **Scofield v. Lewis,** the Fifth Circuit also emphazised its belief that the taxpayer there elected to use the unit-livestock-price method, and thereby subject his breeding herd to valuation by the same method, before it was known that the gain upon the sale of a breeding herd could be treated as capital gain rather than ordinary income. It should be noted that the taxpayer in **Lewis** had carried his breeding herd in inventory since 1939. On the other hand, in the instant case, the taxpayer has been engaged in the business of raising Angus cattle only since 1947 (R. 27-38), and the Court of Appeals pointed out (Pet. A 22) that, in 1944, the Internal Revenue Service issued I.T. 3666, 1944 Cum. Bull. 270, recognizing that capital gains treatment was available upon disposition of breeding cattle if all other necessary elements were satisfied. Therefore, the taxpayer here, **unlike the taxpayer in the Lewis case,** did have a meaningful option with respect to his accounting method when he went into business in 1947." (Emphasis Added)

Commissioner, 257 F.2d 595, limiting the applicability of **Lewis** to its facts, is distinguishable. There, a taxpayer using the farm price method to value inventory had an option (which was not available to the taxpayer in **Lewis** and in the instant case) to include purchased breeding livestock in inventory or not as he chose. See Treas. Reg. §1.61-4(b), **infra.**

The Petitioner's attempt to blame Congress for the disparity of treatment between cash and accrual basis taxpayers is clearly unwarranted. (Pet. 13). The legislative history of Section 117(j) reflects that Congress was concerned only with one consideration, namely, to specifically authorize capital gain treatment for livestock. Neither of the Committee Reports reflect that Congress was even aware of the Commissioner's discriminatory Regulation or the effect the amendment would have on cash and accrual basis taxpayers. S. Rep. No. 781, 82d Cong., 1st Sess., p. 42; H. Rep. No. 486, 82d Cong., 1st Sess., p. 32. Similarly, the Petitioner's assertion (Pet. 14) that the Regulation achieved the force of law through statutory re-enactment is untenable in that (a) Petitioner has failed to establish that Congress had general or specific knowledge of the Regulation in question;[5] (b) the Regulation was not in fact a construction or interpretation of the Statute but was an invalid provision in conflict with the statute, and (c) the statute is clear and

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[5] **Mertens,** Law of Federal Income Taxation, Vol. 1, §3.24, pp. 49-52.
The letter from the Secretary of Treasury to the Chairman of the Senate Finance Committee (98 Cong. Rec., Pt. 6, pp. 8307-8308) referred to in the Petition (Pet. 13) can scarcely be regarded as apprising Congress in most thorough and clear terms of the way in which Commissioner was administering the law. There is no mention or reference to the Regulation nor to the fact that the Commissioner was requiring taxpayers who use the unit-livestock-price method to include raised breeding livestock in inventory.

unequivocal and therefore the rule of statutory re-enactment has no application.[6]

When Congress authorized capital gain treatment on livestock the Regulation became invalid because in conflict with the statute. At that time it became incumbent upon the Commissioner to change the Regulation. His refusal to do so is but another of his unyielding efforts to limit and deny capital gain treatment to the livestock industry.

2. Taxpayers are Entitled to Correct the Error Caused by the Invalid Regulation

Having included raised breeding livestock in inventory in compliance with the invalid Regulation taxpayers are entitled to correct the error and remove such livestock from inventory.[7] The correction of the error is not a change in accounting method which necessitates the Commissioner's consent. **Scofield** v. **Lewis,** 251 F.2d at 132, **United States v. Catto,** (Pet. 12). Moreover, even if a change of accounting method was involved, it would have been useless for these taxpayers to have filed a request as the Commissioner arbitrarily refused to consider an application to change.[8] While the Commissioner may have been vested with discretion to refuse an applica-

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[6] **Mertens,** Law of Federal Income Taxation, Vol. 1, §3.24, p. 48.

[7] There is nothing in the record in this case to support the conclusion that correction of the error would give taxpayers an inordinate deduction against ordinary income in the year in which the correction is made. [Pet. 16, citing dicision of Court of Appeals (Pet. App. A, p. 21)] This would depend on the taxpayers' tax bracket at the time of inclusion and time of removal, about which there is nothing in the record.

[8] It was stipulated that during the years 1954-1958, the Commissioner refused to consider rancher's requests to change from the accrual method to the cash receipts and disbursements method. (R. 9). A similar situation existed in prior years, **Scofield** v. **Lewis,** 251 F.2d at 131.

tion, he was required to exercise his discretion and could not arbitrarily determine issues without even considering the merits. **United States v. Shaughnessy,** 347 U.S. 109, 121; **Yellen** v. **United States,** 374 U.S. 109, 121.

3. No Question of Importance to the Federal Tax Law is Presented.

Taxpayers take exception to the Petitioner's assertion (Pet. 17) that the question presented potentially affects large numbers of taxpayers and will have a substantial impact upon the revenue. The decision of the Court of Appeals has very limited application. As the Petitioner forcefully argued in opposing certiorari in the **Ekberg** case, it only applies to taxpayers who elected the unit-livestock-price method prior to the enactment of Section 117(j) of the Internal Revenue Code of 1939. In addition the District Court in the instant case further restricted the application of the **Lewis** case to those taxpayers who timely correct the error in inventory practices resulting from the invalid regulation (R. 48), of whom there can be but a few at this date.

CONCLUSION

The facts and the legal principles involved in **Lewis** and the instant case are identical. The Petitioner successfully opposed certiorari in **Ekberg** on the ground that there was no conflict. This Court recognized the validity of that argument by denying certiorari. Now the petitioner seeks to do a 180 degree turn. Suddenly, a conflict exists. The petitioner cannot have it both ways. Taxpayers urgently assert that this Court was correct in

denying certiorari in **Ekberg.** It follows that it should be denied here.

Respectfully submitted,

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October, 1965.

APPENDIX

Internal Revenue Code of 1954:

Sec. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * *

(e) **Requirement Respecting Change of Accounting Method.** — Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate. (26 U.S. C. 1964 ed., Sec. 446.)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) **General Rule.** — If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more

than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

(b) **Definition of Property Used in the Trade or Business.** — For purposes of this section.

(1) **General Rule.** The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not —

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition or similar property, held by a taxpayer described in paragraph (3) of section 1221.

* * *

(3) **Livestock.** — Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * *

(26 U.S.C. 1964 ed., Sec. 1231.)

Treasury Regulations on Income Tax (1954 Code):

§1.61-4 Gross income of farmers.

(a) **Farmers using the cash method of accounting.** A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year -

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources. The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale or purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). * * *

(b) **Farmers using an accrual method of accounting.** A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in sub-paragraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in subparagraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471.
* * *

* * *

§446.1 General rule for methods of accounting.

* * *

(e) Requirement respecting the adoption or change of accounting method. * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material

item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

* * *

§1.471-6 Inventories of livestock raisers and other farmers.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of §1.446.1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of

animals according to either the "farm - price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of §1.446.1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal with a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and

the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-live-stock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragrah (e) of §1.446-1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market, whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, PETITIONER

v.

JOHN CATTO, JR., AND ROXANA CATTO

UNITED STATES OF AMERICA, PETITIONER

v.

W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. W. WARDLAW, DECEASED, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

1. Respondents argue that the Fifth Circuit's decisions in the instant cases do not conflict with the decisions of the Eighth and Ninth Circuits. They state that the Fifth Circuit has held the instant Treasury Regulation invalid only as to taxpayers who chose the unit-livestock method before 1944—the earliest date (according to respondents) that cattle raisers could have known they were entitled to capital gain—while the Eighth and Ninth Circuits upheld the Reg-

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ulation only in cases involving taxpayers who had a post-1944 choice.

The facts of the present cases refute that contention. The respondents in the instant *Catto* case could have changed their method of accounting in 1948 or 1951, well after a "meaningful option" was available. (See *Wardlaw* Br. in Opp. 20; *Catto,* R. 39, fn. 1.) The respondents in *Wardlaw,* on the other hand, could not have changed their method of accounting after 1944. Nevertheless, the Fifth Circuit stated that the questions presented by *Catto* and *Wardlaw* were "identical" (Pet. 18, fn. 1). The court clearly recognized that its position was in conflict with that of the Eighth and Ninth Circuits (Pet. 20, fn. 4).

It is clear that the Fifth Circuit rested its decisions in the instant cases on the dichotomy between cash and accrual basis ranchers and not, as respondents contend, upon whether a rancher had a choice of accounting methods after 1944.[1]

[1] The principal reason the government opposed certiorari in *United States* v. *Ekberg*, 291 F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920, was because at that time the Fifth Circuit's position was in doubt. (See Pet. 5–6.) The instant cases, of course, remove any such doubt.

The government's *Ekberg* brief in opposition also distinguished the Fifth Circuit's *Lewis* holding on the ground that the taxpayers in *Lewis* had no choice of accounting methods after 1944 while the taxpayers in *Ekberg* did. This statement was meant only to demonstrate that no clear conflict existed, since there was no assurance that the Fifth Circuit would have reached a result contrary to the Eighth Circuit on the basis of the facts presented in *Ekberg*. (The instant decisions, of course, now demonstrate that it would have.) The government does not, however, believe that the Regulations here in question are invalid as to any taxpayer, including one who had no opportunity to change accounting methods after 1944.

2. Respondents urge that the Treasury Regulation here in question is invalid because it requires them to include raised breeding animals, on which they are entitled to capital gain, in inventory. As we pointed out in our petition and as respondents admit in their briefs, the sole purpose of this provision in the Regulations is to require accrual method ranchers to capitalize the costs of raising breeding animals so that at the time they are sold the excess of the sales proceeds over accumulated raising costs will constitute capital gain. (See, *e.g.*, Pet. 8–10; *Wardlaw* Br. in Opp. 13, 14, fn. 16.)

Because it is virtually impossible to determine exactly which of a rancher's expenses are attributable to raising his breeding animals, this result is accomplished by a two-step procedure: (1) The taxpayer deducts all of his expenses; (2) the taxpayer then adds to income an estimate of the costs of raising his breeding animals. This has the effect of reducing his deductible expenses by the amount of the costs attributable to raising the breeding animals. This portion of his expenses (which is not currently deductible) is then added to the animals' cost basis.

This procedure does not, by any stretch of the imagination, violate the purpose of § 1231, which entitles ranchers to capital gain treatment on the "gains" from sales of breeding animals. The word "gain" is, of course, defined elsewhere in the Code as the excess of the sales proceeds over the accumulated cost or other basis of the property sold. 1954 Code §§ 1001, 1011–1013. Thus by requiring accrual method ranchers to accumulate the costs

of raising breeding animals, the Regulations do not conflict with § 1231; they merely treat accrual method ranchers the same as taxpayers in other businesses.

Respectfully submitted.

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SUPREME COURT OF THE UNITED STATES

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH COURT

REPLY BRIEF FOR JOHN CATTO, JR. AND ROXANA CATTO

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1. Petitioner in its Reply Brief argues that the facts in the instant case are indistinguishable from the **Ekberg** case and therefore a conflict exists between the decisions of the Fifth and Eighth Circuits. In support of its argument the Petitioner asserts that the taxpayers in the instant case "could have changed their method of accounting in 1948 and 1951, well after a 'meaningful option' was available." Such an assertion is clearly erroneous and unwarranted.

When the taxpayers began operating the ranches as a partnership with taxpayer, Roxana Catto's sister and her husband in 1938, they used the accrual (inven-

tory) method and valued inventory under the unit-livestocks-price method (R. 41.).[1] If the taxpayers had attempted to change from the accrual method to the cash method when the taxpayers continued operating the ranches as sole proprietorships they would have been required to secure the Commissioner's consent.[2]

There is no question, and the **Lewis** case clearly shows, that such a request by these taxpayers would have been neither considered nor approved by the Commissioner. Thus, the instant taxpayers made their election before it was known that gain upon the sale of breeding livestock could be treated as capital gain. Therefore, the facts in the instant case are indistinguishable from **Lewis**[3]. Accordingly, these taxpayers, like the taxpayer in the **Lewis** case, did not have a "meaningful option" when they began ranching operations in 1938; nor did they subsequently have such an option because of the Commissioner's arbitrary policy not to consider applications to change from the accrual to the cash basis.

2. Finally, respondent would like to note that the Petitioner has not demonstrated in its Petition or Reply Brief that a question of importance to the Federal tax law is presented. Respondents submit that the point here

---

[1] This method was first adopted by taxpayer — Roxana Catto's father and mother in approximately 1920 and was continued by various partnerships which operated the ranches until 1938. (R. 41, fn. 2).

[2] See Letter of the Deputy Commissioner, January 5, 1945, 45-1 C.C.H. §391.459, where the Internal Revenue Service ruled that if income from a business operated by an individual was reported on the accrual basis and such business is suceeded by a partnership, permission of the Commissioner is required to change to the cash method.

[3] The Government conceded before the Court of Appeals that Lewis was indistinguishable if the Commissioner's consent would have been required to change from the accrual to the cash method. (Appellant's Reply Brief, p. 6.).

involved is extremely narrow and very limited in application and for this reason alone would not warrant review by this Court.

Respectfully submitted,

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October, 1965.

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No. 535

In the Supreme Court of the United States

OCTOBER TERM, 1965

UNITED STATES OF AMERICA, *Petitioner*

vs.

W. H. WARDLAW, *Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

ANSWER BY RESPONDENT TO REPLY BRIEF OF PETITIONER

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ge Supreme Court of the United States

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I PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

ISWER BY RESPONDENT TO REPLY BRIEF OF PETITIONER

In his Reply Brief, petitioner finally admits that taxpayers in the **Wardlaw** case, like the taxpayer he **Lewis** case, did not have a meaningful choice ply Brief, p.2). This lack of meaningful choice precisely the ground on which the Government, ts brief opposing the petition for a writ in the **erg** case, argued that the **Lewis** case was distin-shable from, and therefore not in conflict with, **erg.** Clearly then, on the very same ground, **Ward-** is distinguishable from, and not in conflict with, **erg.** Hence, review of the **Wardlaw** case by this rt is not necessary.

Petitioner is fully aware that there is no ground for his request that a writ of certiorari be issued in the **Wardlaw** case, since, by his own admission, **Wardlaw** is distinguishable from, and hence not in conflict with, **Ekberg.** Consequently, in the belief that he has a tenable argument that the **Catto** case conflicts with **Ekberg,** petitioner continues his efforts to treat the **Wardlaw** and **Catto** cases as if they were one and the same, even while he (a) admits that the taxpayers in the **Wardlaw** case did not have a meaningful choice because they "could not have changed their method of accounting after 1944", and (b) argues that the taxpayers in **Catto** did have a meaningful choice because they "could have changed their method of accounting in 1948 or 1951, well after a 'meaningful option' was available." (Reply Brief, p.2).

While petitioner obviously does not believe that the **Wardlaw** and **Catto** cases are factually alike, having taken the position that they differ on the vital point of meaningful choice, nevertheless petitioner would have this Court treat the two cases as if they were one and the same simply because a statement in the **Catto** opinion says that the appeal in that case "once again raises the problem of the tax and accounting treatment to be accorded raised breeding cattle which are sold by an accrual basis taxpayer", and that the same "issue is raised" in the **Wardlaw** case. Beyond question, the **Wardlaw** case does involve the problem of the tax treatment to be accorded raised breeding cattle sold by accrual basis farmers, just as the **Lewis** case involved this issue, and the **Ekberg** case, and the **Little** case; but finding that two cases involve the same general issue is no support whatever

for the argument that the two cases should be treated as if they were one and the same, so that if **Catto** should conflict with **Ekberg**, then **Wardlaw** would therefore conflict. By this sort of reasoning, it would be necessary to conclude that the **Lewis** case is exactly like the **Ekberg** case, because they both involve the same issue, but, as the petitioner himself has pointed out, these two cases are distinguishable and therefore could not possibly be treated as one and the same, because in one case the taxpayer had a meaningful choice and in the other he did not. For precisely the same reason, the **Wardlaw** and **Catto** cases cannot be treated as if they were one and the same: by petitioner's own admission, the taxpayers in the **Wardlaw** case did not have a meaningful choice and, by petitioner's own contention, the taxpayers in the **Catto** case did.

Petitioner originated, and used successfully before this Court, the argument that a case could not conflict with **Ekberg** if the taxpayer involved did not have a meaningful choice. For this reason there was no conflict between **Lewis** and **Ekberg**. For the same reason, there is no conflict between **Wardlaw** and **Ekberg**. In the **Catto** case, the trial Court held that the taxpayers there did not have a meaningful choice; hence, there is no conflict between **Catto** and **Ekberg**. The only argument petitioner has is in the **Catto** case, and his argument there is very limited: He cannot deny that the trial Court ruled that the taxpayers did not have a meaningful choice; he can only argue that the Court used the wrong cut-off date in deciding when a choice becomes meaningful. (See Wardlaw Br. in Opp., p.14, Fn. 17). Clearly, this is a very narrow point on which

to rest a petition for review by the Supreme Court of the United States.

Petitioner next says that "It is clear that the Fifth Circuit rested its decisions in the instant cases on the dichotomy between cash and accrual basis ranchers", and not upon whether a rancher had a meaningful choice. (Reply Brief, p.2). Surely this argument is not advanced seriously, because the Court of Appeals in each of these two cases clearly stated that it was following the **Lewis** case, which, as petitioner himself pointed out when he opposed the issuance of a writ in the **Ekberg** case, **was decided on the ground of a lack of meaningful choice.** Petitioner's present argument places him in the ridiculous position of contending either (a) that the instant cases are not based on **Lewis,** or (b) that the **Lewis** case really turned on the dichotomy between cash and accrual basis ranchers, and not on the question of meaningful choice, and that four years ago he asked this Court to distinguish the **Lewis** case on the basis of facts that had nothing to do with the decision!

In the second part of his Reply Brief, petitioner repeats what he has said many times before, namely, that the sole purpose of the Regulation in question is to require accrual method ranchers to capitalize the costs of raising breeding animals, petitioner's implication being that there should certainly be no objection to a Regulation requiring that such costs be capitalized. The petitioner points out that this capitalizing of raising costs is accomplished by a

> "two-step procedure: (1) The taxpayer deducts all of his expenses; (2) the taxpayer then adds

to income an estimate of the costs of raising his breeding animals. **This has the effect of reducing his deductible expenses by the amount of the costs attributable to raising the breeding animals."** [Emphasis added.]

Petitioner has indeed correctly described exactly how the Commissioner permits a deduction of raising costs with one hand, and immediately takes the deduction away with the other! **The result, of course, is that the farmer gets no deduction for his raising costs, despite the fact that the right to deduct the costs of raising breeding animals has been specifically granted by the Regulations for the last 44 years!**

Finally, no court has ever accepted Regulation 1.471-6(g), which is the regulation requiring that raised breeding animals be included in inventory, as binding unless the taxpayer had an opportunity to avoid its impact by having a meaningful choice as to accounting methods and methods of valuing inventories.

Respectfully submitted,

CLAIBORNE B. GREGORY

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Attorneys

October 19, 1965

CERTIFICATE OF SERVICE

It is hereby certified that service of this Answer has been made on opposing counsel by depositing five (5) copies thereof in the United States Mail (Air Mail) with postage prepaid, addressed to THURGOOD MARSHALL, Solicitor General of the United States, Department of Justice, Washington, D.C., 20530, and by depositing one (1) copy thereof in the United States Mail with postage prepaid, properly addressed to ERNEST MORGAN, United States Attorney for the Western District of Texas, Federal Bldg., San Antonio, Texas, on this the 21st day of October 1965.

Elwood Cluck

ELWOOD CLUCK

Attorney for W. H. Wardlaw,
Independent Executor of the Estate
of Crawford W. Wardlaw
Deceased, et al, Respondents

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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, *Petitioner*

v.

JOHN CATTO, JR. AND ROXANA CATTO

UNITED STATES OF AMERICA, *Petitioner*

v.

W. H. WARDLAW, Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The district court did not file an opinion. Its findings of fact and conclusions of law in *Catto* (R. 34-43) are reported at 223 F. Supp. 663, and in *Wardlaw* (R. 50-64) at 223 F. Supp. 631. The respective *per curiam* opinions of the court of appeals (R. 46-48, 104-106) are reported at 344 F. 2d 227 and 344 F. 2d 225.

JURISDICTION

The judgments of the court of appeals were entered on April 8, 1965 (R. 49, 107-108). Mr. Justice Black extended the time for filing a petition for a writ of certiorari to and including September 5, 1965 (R. 108-111). The petition for a writ of certiorari was filed on September 3, 1965, and granted on November 22, 1965 (R. 112). This Court has jurisdiction under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Ranchers are, in general, entitled to capital gain treatment on profits from the sale of breeding livestock which they use to produce animals marketed for purposes of slaughter. Long standing Treasury Regulations require taxpayers who (like those involved in the instant cases) use the accrual method of accounting to capitalize the costs of raising breeding livestock and then to report as capital gain the excess of the animals' sales proceeds over their accumulated cost basis. Respondents consistently complied with these regulations, but subsequently brought suits for refunds claiming the right (1) to deduct against ordinary income all of the costs of raising their breeding animals, thus giving them a zero cost basis in the livestock and (2) to report the full proceeds of sale as capital gain. The questions presented are:

1. Whether, contrary to Treasury Regulations, ranchers using the accrual method of accounting may transform ordinary income into capital gain by deducting against current income the cost of raising breeding livestock and then reporting the entire proceeds from their sale as capital gain.

2. Whether a court may permit taxpayers to revise materially their consistent method of reporting income by adopting a hybrid accounting system, when those taxpayers did not first make application to the Commissioner for permission to change their method of accounting as required by the Internal Revenue Code of 1954, § 446(e).

STATUTES AND REGULATIONS INVOLVED

Sections 446(e), 1001(a), 1012, 1013, 1016(a)(1), and 1231 (a) and (b)(3) of the Internal Revenue Code of 1954, and Sections 1.61-4, 1.162-12, 1.167(a)-6(b), 1.446-1(e)(2)(i), and 1.471-6 of the Treasury Regulations (1954 Code), appear in the Appendix, *infra*, pp. 33-42.

STATEMENT

The pertinent facts in both suits were stipulated and are substantially the same. For the most part, it will be unnecessary to distinguish between them. Respondents are ranchers who raise livestock for sale.[1] As an incident of this business they also raise breeding cattle which they use to produce beef animals. Each of the respondents elected to report his income on a variant of the accrual method of accounting, called the

[1] Eight cases were consolidated for trial in *United States* v. *Wardlaw;* that case and *United States* v. *Catto,* have been consolidated herein. The years involved vary from case to case, but cover 1954 through 1959, inclusive (R. 6, 35, 54). The various respondents raise cattle, sheep and goats (R. 36, 55). The legal principles are the same regardless of which animals are involved. For simplicity, we will refer to them all as cattle; the term "beef animals" or "beef cattle" refers to livestock which are marketed for purposes of slaughter, while the term "breeding animals" or "breeding cattle" will be used to designate livestock used to produce the beef animals.

unit-livestock-price method. This method permits the rancher to use estimates in lieu of the actual cost of raising cattle for purposes of valuing cattle on hand at the end of the tax year. As required by the Regulations, respondents consistently used this estimated-cost method of accounting for both the beef and breeding cattle which they raised. (R. 2-4, 36-38, 56-58.)

During the years here in question, respondents sold some animals which they had held for breeding purposes for more than 12 months and reported the profit as capital gain under Section 1231 of the 1954 Code. They computed their gain on these sales by deducting from the sales proceeds the cost basis of the breeding cattle sold (calculated according to respondents' estimated-cost method of accounting). However, they subsequently filed claims for refund, contending that they should not have capitalized the cost of raising their breeding cattle. They claimed (1) that the entire accumulated cost of the breeders should be deducted against ordinary income, thus giving them a zero cost basis in the cattle, and (2) that the entire proceeds from the sale of breeding cattle should be treated as capital gain. At no time had respondents requested the Commissioner's permission to change their method of accounting. The Commissioner rejected the refund claims. (R. 38-39, 58-59.) Respondents then sued for a refund and the district court rendered judgment in their favor. (R. 39, 43, 59, 100.) The Fifth Circuit affirmed *per curiam* on the authority of its earlier decision in *Scofield* v. *Lewis,* 251 F. 2d 128, and held invalid the Treasury Regulation requiring ranchers on the unit-livestock-price method of accrual accounting to accumulate the estimated cost of raising breeding cattle (R. 46-48, 104-106).

INTRODUCTION AND SUMMARY OF ARGUMENT

A taxpayer who incurs an expenditure in the course of earning income is normally entitled to offset that expenditure against income on his tax return. There are, however, two questions to be resolved with respect to each such expenditure. One is the timing of the deduction and the other is the type of income against which the expenditure is to be offset.

For example, let us assume that a taxpayer who is in the business of manufacturing steel products expends $10,000 in building and installing a new punch press for use in manufacturing the steel products he sells. He would not be permitted an immediate deduction for this expenditure. Instead, he would be required to defer these costs (which would thereafter be called the punch press' basis). If, because of a change in his business, the taxpayer sold the punch press the next year, the deferred cost of building the machine ($10,000 less any depreciation deducted in the meantime) would be offset against the proceeds of sale in computing the gain or loss on the transaction. If the gain from the sale constituted capital gain, the deferred cost of building the machine would reduce the amount of capital gain; if the gain from the transaction constituted ordinary income, the deferred costs would reduce ordinary income. 1954 Code §§ 1231, 1001, 1012, 1016, 263; Treas. Reg. § 1.263(a)-2(a); *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179.

Similarly, if the same taxpayer expends $5000 in manufacturing steel products (his normal inventory items), and at the end of his tax year these steel products are still on hand, he is not entitled to a deduction for such costs, but must defer them until the items are sold. When he sells the inventory, he may offset

the accumulated costs (*i.e.*, the inventory's basis) against the proceeds from its sale. 1954 Code § 1001, 1013. See *Doyle* v. *Mitchell Brothers Co., supra; Spring City Co.* v. *Commissioner,* 292 U.S. 182, 185; *Snyder* v. *Commissioner,* 295 U.S. 134, 141 n. 4.

Respondents are all in the business of raising and selling cattle for slaughter. As an incident of this business, they also raise breeding animals which they use to produce beef cattle. It is clear that respondents' profits on the sale of beef animals are taxed as ordinary income (the same as a manufacturing enterprise's profits on sales of its inventory) and that respondents' profits on the sale of breeding animals held for one year or more are taxed as capital gains (like an industrial concern's profits on sale of machinery and equipment).[2] 1954 Code § 1231(b)(3). It is also undisputed that respondents—all of whom have elected the accrual method of accounting—must defer the costs of raising their *beef* cattle and offset these accumulated costs against the proceeds when the animals are sold. The sole question here in dispute is whether respondents must also defer the costs of raising their *breeding* animals and offset these accumulated costs (less de-

[2] Actually profits of this nature are taxed under 1954 Code § 1231 which requires a taxpayer to combine all of his gains and losses from the disposition of certain assets, such as plant and equipment, and if the net result is a gain, provides that it shall be taxed as a capital gain, but if the net result is a loss, provides that it shall be treated as an ordinary loss. It is, of course, to the taxpayer's advantage to treat his net profit as a capital gain and his net loss as an ordinary loss. Therefore, § 1231 treatment is even more advantageous for the taxpayer than straight capital asset treatment (where both net gains and net losses are capital in nature). For simplicity, breeding cattle will be referred to herein as a capital asset, although, technically speaking, they are § 1231 assets.

preciation, if any) against the proceeds when the breeding animals are ultimately sold.

The basic Regulations dealing with methods of accounting for farmers and ranchers were adopted in 1924. They afford farmers and ranchers a choice between a simple cash method of accounting under which they deduct the costs of raising their crops and animals as incurred and a more sophisticated accrual method under which they accumulate such costs and deduct them against the proceeds realized upon sale of the crops or animals. Although respondents elected the accrual method of accounting, they now claim that changes in the tax treatment of profits realized on disposition of breeding cattle entitle them to unilaterally adopt a hybrid method of accounting without requesting permission from the Commissioner, *i.e.,* to use the accrual method of accounting for beef animals and the cash method for breeding animals.

We will show in Point I that cash method ranchers and farmers are permitted to deduct the costs of raising their crops and animals only because their practical circumstances make it advisable that they be offered an extremely simple method of accounting; and in Point II that Congress has expressly recognized that taxpayers, like respondents, who have rejected bookkeeping simplicity for accounting accuracy by electing the accrual method are not entitled either to revoke their election and switch to the cash method or to adopt a hybrid method of accounting embodying the advantages of both systems without the disadvantages of either.

In Point III, we will show that the unit-livestock-price method of valuing inventory (elected by all respondents) is one acceptable method of deferring the costs attributable to raised cattle until they are sold.

Regardless of the terminology used, the practice of including breeders in inventory does not prevent respondents from reporting the profits from the sale of raised breeders as capital gain. It merely requires them to accumulate the costs of raising breeders and offset such costs against the proceeds of sale in computing the amount of capital gain. Thus, the mechanics of the unit-livestock-price variant of the accrual method are completely in harmony with the relevant Code provisions discussed in Points I and II.

ARGUMENT

I.

The Dichotomy Between Cash and Accrual Method Ranchers is Supported by Sound Accounting Practice and by History and Has Been Approved by Congress.

The essence of respondents' complaint and the lower courts' holding is that ranchers who have elected the accrual method of accounting are being treated differently from ranchers who have chosen the cash receipts and disbursements method of accounting. Accrual method taxpayers are required to defer the costs of raising both breeding and beef animals and to offset the accumulated costs of such animals against the proceeds from their eventual sale in computing gains (which in the case of beef cattle is ordinary income and in the case of breeding animals is capital gain). Treas. Reg. §§ 1.61-4(b), 1.471-6.[3] Cash method taxpayers, on the other hand, are permitted to deduct each year the costs incurred in raising cattle (both beef and breeding); they thus accumulate no cost basis for the animals and upon sale the entire proceeds constitute gain

[3] Unless otherwise indicated, citations to Treasury Regulations refer to those under the 1954 Code.

(ordinary income in the case of beef cattle and capital gain in the case of breeders). Treas. Reg. §§ 1.61-4(a), 1.162-12. Therefore, taxpayers on the cash method of accounting deduct the costs of raising breeding cattle against ordinary income while accrual method ranchers deduct the costs of raising breeders against the capital gain received upon the sale of such animals. Respondents argue that, although they elected the accrual method of accounting for their ranching operations, they should nevertheless be permitted, contrary to the Treasury Regulations and the Commissioner's settled practice, to deduct the costs of raising breeding cattle against ordinary income, as are cash method taxpayers. We submit that this long-standing dichotomy in treatment between cash and accrual ranchers is supported by sound accounting practice and by history and has been approved by Congress. The lower court erred, therefore, in holding the Regulations invalid.[4]

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[4] All of the other courts to consider this question have agreed with the government. See *Little* v. *Commissioner*, 294 F. 2d 661 (C.A. 9); *United States* v. *Ekberg*, 291 F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920; *Visintainer* v. *United States*, 301 F. 2d 312 (C.A. 10); affirming *per curiam* 191 F. Supp. 425 (D. Colo.); *Banks* v. *Commissioner*, 322 F. 2d 530 (C.A. 8); *Irvine* v. *United States*, 212 F. Supp. 937 (D. Wyo.); *Tee Bar Ranch Co.* v. *United States*, (D. Mont.), decided August 2, 1963 (63-2 U.S.T.C. par. 9663); *Gibbs* v. *Commissioner*, 33 T.C. 27; *Frost* v. *Commissioner*, 28 T.C. 1118; *SoRelle* v. *Commissioner*, 22 T.C. 459.

Indeed, the Fifth Circuit expressed misgivings about the result it felt itself compelled by *stare decisis* to reach in the instant cases. The Fifth Circuit first considered the question presented here in *Scofield* v. *Lewis*, 251 F. 2d 128, and decided against the government. Shortly thereafter, it cast doubt on the validity of that decision by stating that "the principle of the *Lewis* case should not be extended beyond its own facts." *Carter* v. *Commissioner*, 257 F. 2d 595, 600. Nevertheless, in its *per curiam* opinions in the instant cases, the Fifth Circuit felt bound to adhere to *Scofield* v. *Lewis* without reexamination "until its legislative

A. The basic regulations which created this dichotomy between cash and accrual farmers and ranchers were promulgated at least as early as 1924. See Regulations 65, Arts. 38, 111, 1616 (1924 Revenue Act). Compare 1954 Treas. Reg. §§ 1.61-4, 1.162-12, 1.471-6 (1954 Code).

Although most taxpayers who incur expenses in manufacturing an item, whether it be inventory or a capital asset, have always been required to accumulate their costs of production and offset them against the proceeds of sale in computing gain, even if they are on the cash method of accounting,[5] the Commissioner concluded, for a number of reasons, that he should make an even simpler method of accounting available to farmers and ranchers.[6] A farm or ranch was typically a family operation, located far from any urban population center. The small size of most farming operations and their location made it impractical to obtain the services of professional accountants. Thus, the family members and their employees usually main-

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or judicial demise" (R. 48; see also R. 105). However, it expressed reluctance at following this course of action for 5 reasons: (1) the government had presented "impressive conceptual arguments [which were] perhaps not fully advanced [in *Lewis*]," (2) "express rejection of *Lewis* by the 8th and 9th Circuits" had "generated" "doubts" as to that decision's correctness, (3) even "this Court [in *Carter*] has severely limited * * * [*Lewis'*] applicability," (4) the court was "fully cognizant of the anomaly of allowing such tax treatment of a capital asset" as is requested by respondents, and (5) the decision in favor of the taxpayers "results in an inordinate deduction against ordinary income in the year in which the correction is made" (R. 48, 105).

[5] See 1954 Code §§ 263, 1001, 1012, 1013, 1016; Treas. Reg. §§ 1.263(a)-2(a), 1.471-1, 1.1016-2(a).

[6] See Letter of June 27, 1952, from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, 98 Cong. Rec., Pt. 6, pp. 8307-8308, reprinted R. 9-15 (hereinafter referred to as 1952 Letter to Congress).

tained the business records and prepared the tax returns. As a rule, these individuals were unfamiliar with the complexities of an accrual system of accounting. Moreover, the nature of farming and ranching operations made an effective accrual system of accounting difficult to operate. Each employee almost invariably worked on numerous phases of the farm's profit-making endeavors, such as planting and harvesting crops, raising livestock, repairing fences and barns, etc. Thus, it was exceedingly difficult to allocate salaries and the other expenditures among the various farming operations. Consequently, as early as 1924 the Treasury Regulations created a simplified cash method of accounting for farmers and ranchers, under which they were permitted to deduct their expenditures for raising crops and animals as incurred. Regulations 65, Arts. 38, 111 (1924 Revenue Act).

However, the Commissioner recognized that the income of a farm or ranch, just as that of an industrial concern, would be more accurately reported if the costs of raising crops or animals were accumulated until the crops or animals were sold and deducted against the sales proceeds to determine the profit or loss on the transaction as a whole.[7] Therefore, the Treasury Regulations have since 1924 permitted farmers and ranchers to choose the more sophisticated accrual method of accounting, under which they are required to accumulate the costs of raising crops and animals and offset them against sales proceeds. Regulations 65, Arts. 38, 1616 (1924 Revenue Act).

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[7] Because taxpayers on the cash method frequently deduct the expenses of raising crops or livestock in one year but do not sell them until a later year, the cash method often results in a bunching of income and an inaccurate matching of income with expenses.

Consequently, in keeping with their needs, the Regulations have for more than forty years given ranchers and farmers the widest possible choice between a simple cash method of accounting on the one hand and a more sophisticated accrual system of accounting on the other.

B. As explained, *supra,* p. 5, there are two basic questions with regard to the deductibility of each business expenditure: the tax period in which it is to be deducted, and the type of income against which it is to be offset. Permitting a cash method rancher to deduct the costs of raising *beef* animals as incurred, instead of requiring him to accumulate these costs and offset them against the proceeds from the sale of the animals, affects only the first of these questions, *i.e.,* the tax period in which the expenditure is to be deducted. Since the gain from sales of beef animals is ordinary income, the expenditure would offset ordinary income regardless of whether it is deducted in the year incurred or accumulated and deducted against the proceeds of sale in computing gain.

Moreover, when the Regulations creating the cash and accrual methods of accounting for ranchers were promulgated in 1924, it was thought that the proceeds from sales of breeding cattle also constituted ordinary income. 1952 Letter to Congress, R. 10. Thus, in permitting a cash method rancher to deduct the costs of raising breeders as incurred, the Commissioner believed that he was affecting only the tax period in which the deduction would be allowed and not the type of income against which it would be offset. However, in 1944 the Commissioner ruled for the first time that profits from the sales of raised breeders could constitute

capital gains.[8] Although the Commissioner attempted to restrict the class of breeders that would be subject to capital gains,[9] the courts soon held that virtually all breeders were (like an industrial concern's machinery and equipment) entitled to capital gain treatment.[10] In 1951 Congress explicitly codified the judicial decisions. See Revenue Act of 1951, c. 521, 65 Stat. 452, 501, Sec. 324; now 1954 Code § 1231(b)(3).[11]

When profits on the sale of raised breeding animals began to be taxed as capital gains, cash method taxpayers automatically received an additional tax advantage. No longer did their right to deduct the costs of raising breeders as incurred merely affect the timing of the deduction. Thereafter, it also affected the type of income against which the expenditures would be offset. By deducting the expenses of raising breeders against ordinary income as incurred instead of against the capital gain derived upon sale of the breeders, cash method ranchers were able to reduce their ordinary income and replace it with a corresponding increase in capital gain; this produced a tax saving because ordinary income is taxable at higher rates than capital gain.

At this point the Secretary of the Treasury and the Commissioner of Internal Revenue examined the feasibility of amending the regulations to require cash basis ranchers to accumulate the costs of raising breeders. However, their detailed study of the 1951 statutory

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[8] I.T. 3666, 1944 Cum. Bull. 270.

[9] See I.T. 3666, *supra;* I.T. 3712, 1945 Cum. Bull. 176.

[10] See, *e.g., Albright* v. *United States,* 173 F. 2d 339 (C.A. 8); *United States* v. *Bennett,* 186 F. 2d 407 (C.A. 5).

[11] Congress did, however, extend from 6 to 12 months the period a taxpayer must hold the animals in order to get capital gain treatment. *Ibid.*

amendment's legislative history convinced them that Congress had precluded such a fundamental change in the cash method of accounting. 1952 Letter to Congress, R. 14. Since 1924 the Treasury Regulations had required accrual method ranchers to accumulate the costs of raising cattle while permitting cash method ranchers to deduct such costs as incurred. Between 1924 and 1951 the Code had been frequently reenacted. Moreover, when the Commissioner, in 1944, first ruled that raised breeders qualified for capital gain treatment under certain circumstances, he specifically noted that under the long-accepted farm and ranch accounting methods cash basis taxpayers would deduct the expenses of raising breeders against ordinary income as incurred and report the entire proceeds from sale as capital gain while accrual method ranchers would, like taxpayers in other industries, accumulate the costs of raising breeders and offset them against the proceeds of sale in order to compute gain. I.T. 3666, 1944 Cum. Bull. 270; I.T. 3712, 1945 Cum. Bull. 176.[12] When Congress amended the Code in 1951 to explicitly confirm that breeders were subject to capital gain treatment, both Committee Reports emphasized that the amount of the capital "gains from sales of [breeding] livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and *presently* recognized by the Bureau of Internal Revenue." S. Rep. No. 781, 82d Cong., 1st Sess., p. 42 (1951-2 Cum.

[12] While I.T. 3666 and I.T. 3712 were revoked in 1951 (Mim. 6660, 1951-2 Cum. Bull. 60), this action was taken only because the courts had uniformly rejected the portions of the rulings limiting the circumstances under which raised breeders would qualify for capital gain. It is clear that the revocation was not intended to modify the Treasury's well accepted rules regarding accumulation of raising costs which are embodied in the Regulations. See 1952 Letter to Congress, R. 9-12.

Bull. 458, 488); H. Rep. No. 586, 82d Cong., 1st. Sess., p. 32 (1951-2 Cum. Bull. 357, 380) (emphasis added). This language unmistakably reflects Congress' awareness that two accounting methods were being used to compute gains on sales of breeding livestock. Congress clearly did not intend the 1951 amendment to alter the computation of gain.

Examination of this legislative history convinced the Secretary of the Treasury that Congress wished to continue the long-standing dichotomy between cash and accrual ranchers. (1952 Letter to Congress, R. 14.) Therefore, in 1952 the Secretary of the Treasury asked Congress to withdraw some of the cash systems' basic simplicity by enacting legislation requiring cash method ranchers to accumulate the costs of raising breeders and offset them against the capital gain proceeds realized upon sale. (1952 Letter to Congress, R. 14-15.) Opposing interests, however, introduced a bill to extend to accrual method ranchers the right to deduct against ordinary income the production costs of breeding livestock. H.R. 3896, 83rd Cong., 1st Sess. (1953). Congress did not adopt either solution to the problem. In fact, two years later when the 1954 Code was enacted, the provision for breeding cattle was retained verbatim (as 1954 Code § 1231).

While the Treasury Department has thus far been unsuccessful in withdrawing this tax advantage from the cash method rancher, it does not follow that an accrual method livestock rancher must be allowed the same windfall. The accrual method results in a correct computation of income, while the cash method causes an understatement of income. (1952 Letter to Congress, R. 11-13.) For example, if it costs $100 to raise a breeder which is ultimately sold for $150, a taxpayer

should have a gain of $50. Under the accrual method a rancher would have a $50 capital gain in such circumstances. However, a cash method rancher would be entitled to deduct the $100 of raising costs against ordinary income as incurred and then would have a $150 capital gain upon sale of the animal. Since a taxpayer can elect to be taxed on one-half of his capital gain, the cash rancher obtains a $100 deduction for the raising costs and only $75 of income upon sale (½ of $150). Thus the cash rancher is taxed as if he had suffered a $25 loss on the transaction.

The cash method rancher is reluctantly allowed this tax advantage only because deduction of raising costs as incurred is a necessary concomitant of his simplified method of accounting. This reasoning does not extend to the accrual rancher, who has elected a more sophisticated system of accounting under which expenses are deferred and matched with the income which they produce. Moreover, the legislative history and statutory reenactment which prevent the Treasury from amending the Regulations relating to cash method ranchers also give the effect of law to the Regulations requiring accrual method ranchers to capitalize the costs of raising breeding animals. *Brewster* v. *Gage,* 280 U.S. 327, 337; *Helvering* v. *Winmill,* 305 U.S. 79, 83; *Boehm* v. *Commissioner,* 326 U.S. 287, 291-292.

C. The Fifth Circuit, in the instant cases, did not disagree with the Commissioner's contention that the Regulations created two rational methods of accounting which adequately meet the needs of the farming and ranching communities. Nor did the court find that respondents, all of whom had elected the accrual method of accounting, were being treated unfairly vis-à-vis accrual method taxpayers in other industries.

Rather, the lower court held the long standing Treasury Regulations governing the accrual method of accounting invalid because cash method ranchers were receiving a tax benefit not afforded to accrual ranchers.

The court held that although respondents had elected the accrual method of accounting, they could nevertheless, contrary to the Regulations, account for their *breeding* animals as if they were on the cash method of accounting—*i.e.*, deduct the costs of raising breeders against ordinary income as incurred and report the full proceeds from the sale of breeders as capital gain—while at the same time continuing to report their gains from the sale of *beef* animals on the accrual method of accounting—*i.e.*, accumulate the costs of raising and offset them against sales proceeds. The court thus permitted respondents to switch to a hybrid method of accounting which gives them both the tax advantages of the cash method (current deduction against ordinary income for the costs of raising breeders) and the accounting advantages of the accrual method (matching of income and expenses on beef animals). This hybrid method allows respondents to match income and expenses when it is to their advantage (*i.e.*, on beef cattle) and to refuse to match income with expenses when they get a tax advantage from deducting such expenses as incurred (*i.e.*, on breeders).

In creating this special hybrid method of accounting for respondents, the lower court completely disregarded the fact that cash method farmers and ranchers are reluctantly allowed to deduct the costs of raising crops and animals as incurred only because that is an unfortunate but essential concomitant of their simplified method of accounting. Since the respondents have elected the more sophisticated accrual method of ac-

counting under which they capitalize the costs of raising their animals, it is incongruous indeed to permit them to dispense with this practice as to their breeding herd while requiring them to maintain it as to their beef herd. See *Little* v. *Commissioner,* 294 F. 2d 661, 663-664 (C.A. 9). Although the Fifth Circuit was "fully cognizant of the anomaly of allowing such tax treatment of a capital asset" (R. 48), that is exactly what it did in the instant cases by holding invalid the Treasury Regulation requiring accrual basis ranchers to capitalize the costs of raising breeding animals.[13]

II.

There Is No Merit to Respondents' Claim That They Have a Right To Use a Hybrid Accounting System Because They Elected the Accrual Method Before the Advent of Capital Gains on Breeding Animals.

Respondents contend that even if both the cash and accrual methods of accounting are proper so that a taxpayer who has willingly elected between them should be required to consistently follow the method selected, nevertheless they should be permitted to change their method of accounting. Respondents' argument goes as follows: They elected the accrual method of accounting before the Service ruled that breeding animals qualified for capital gain treatment. Therefore, at the time they rejected the cash method, they did not realize that at some time in the future cash ranchers would be permitted to deduct the expenses of raising breeders against ordinary income

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[13] As explained *supra* pp. 9-10, fn. 4, the Fifth Circuit stands alone in this regard, two courts of appeals and numerous trial courts having reached the contrary conclusion. Nevertheless, the Fifth Circuit believed itself precluded by principles of *stare decisis* from reexamining its previous ruling on the subject (R. 48, 105).

while accrual ranchers would be required to offset such expenses against capital gains. Consequently, they were never afforded a meaningful choice between the two systems of accounting and should now be permitted to adopt a hybrid method of accounting. We disagree.

A. At least as early as 1924 it was clear that the cash method gave ranchers an immediate deduction for the expenses of raising cattle. See *supra*, pp. 10-11. Respondents, however, in order to obtain a system of record keeping which more accurately reflected their income, chose the accrual method, under which they would defer the costs of raising their animals. There has never been a change in the basic framework of either the cash or accrual methods of accounting. The cash rancher still deducts his raising costs as incurred and reports the full sales proceeds as gain, and the accrual rancher still defers his costs and offsets them against sales proceeds in computing gain from the sale. The only change is that the gains recognized on sales of breeders are now generally taxed as capital gains rather than as ordinary income. However, the way in which the gains are taxed does not alter the basic choice between the two methods of accounting—a choice which respondents have already made. Today, as in 1924, a rancher must still choose between a simple method of accounting which requires a minimum of record keeping and professional assistance and a sophisticated method which more accurately reflects his actual net income.

In the past the very simplicity of the cash method often caused electing taxpayers to receive certain tax advantages, such as an immediate deduction for raising expenses which under good accounting practice

should have been deferred until sale of the animals. Such tax advantages were inherent in any simplified method of accounting. Moreover, such tax advantages were frequently counterbalanced by the cash method's inherent deficiencies in matching income with expenses. The advent of capital gain for raised breeders added another tax advantage to the cash method, but the basic choice remained the same: A farmer or rancher had to choose between the various advantages and disadvantages which are inevitably inherent in the simple cash system of accounting, on the one hand, and a more accurate and sophisticated accrual method of accounting on the other. See *Little* v. *Commissioner,* 294 F. 2d 661 (C.A. 9).

Administration of the tax system would certainly be difficult if every taxpayer were free to modify his accounting system every time there was a change in any of the relative tax advantages of one accounting method over another. Every fluctuation in the rate of tax on ordinary income modifies the tax differential between capital gain and ordinary income, and thus alters the advisability of choosing the cash over the accrual method of livestock accounting. Respondents made the decision between the two principal systems of accounting and the Commissioner is not required to permit them to switch from one method to the other whenever there is a change in one of the variables considered in making the choice.

Congress has given the Commissioner authority to prescribe methods of accounting and has required taxpayers to obtain the Commissioner's consent before making any change in their method of accounting for any material item. See 1954 Code § 446(e); Treas. Reg. § 1.446-1(e)(2)(i); *United States* v. *Ekberg,* 291

F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920; *Irvine* v. *United States*, 212 F. Supp. 937 (D. Wyo.). Cf. *Carter* v. *Commissioner*, 257 F. 2d 595 (C.A. 5); *United States* v. *Wardlaw*, R. 105-106. None of the respondents requested the Commissioner's consent to a change in accounting method. The lower court held that respondents need not comply with Code § 446(e)'s requirement that any taxpayer who wishes to change his method of accounting must first "secure the consent of the Secretary [of the Treasury] or his delegate."[14] Its reason was that the Commissioner has consistently denied ranchers' requests to change to the cash method. (*United States* v. *Catto*, R. 48.) The Commissioner has, as a matter of policy, denied such requests where the only reason for the change was to obtain the tax windfall presently permitted to cash method ranchers. In taking that position, however, the Commissioner has not abused his broad discretion over tax accounting methods (*United States* v. *Ekberg, supra*, cf. *Commis-*

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[14] The keystone of tax accounting is consistency from year to year. The Regulations make this general principle specifically applicable to the special methods of accounting available to farmers and ranchers, such as the unit-price-livestock method. Treas. Reg. § 1.471-6(a). Because a change in the accounting treatment of a material item might result in a drastic distortion of income, the Commmissioner is charged with the responsibility of reviewing accounting changes and making sure that the government will not be harmed by any resultant distortion. See *American Can Co.* v. *Commissioner*, 317 F. 2d 604, 606 (C.A. 2), certiorari denied, 375 U.S. 993; *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249 (C.A. 5); *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225, 230 (C.A. 3), certiorari denied, 368 U.S. 898; *Broida, Stone & Thomas, Inc.* v. *United States*, 309 F. 2d 486 (C.A. 4), affirming *per curiam* 204 F. Supp. 841 (N.D. W.Va.). The court below permitted respondents to change their method of accounting without seeking the Commissioner's consent, although recognizing that the change would give them "an inordinate deduction against ordinary income in the year in which the correcton is made" (R. 48).

sioner v. *Hansen*, 360 U.S. 446, 467); he is not required to permit changes in accounting methods when a taxpayer's current accounting system clearly and accurately reflects his income and expenses. *Brown* v. *Helvering*, 291 U.S. 193; Treas. Reg. § 1.446-1(c)(2)(ii). Respondents did not even attempt to demonstrate that they had any valid business reason for altering their present accounting practices. Therefore, even assuming *arguendo* that a taxpayer could unilaterally change his accounting system without first seeking the Commissioner's consent where he has established a valid business reason for the change, respondents' suits should have failed.

B. Moreover, we submit that Congress has approved the Commissioner's refusal to permit ranchers who have no valid business reason other than tax avoidance to alter their method of accounting. In 1951 Congress explicitly codified the view that "gains" from sales of breeding animals would be taxed as capital gains. Revenue Act of 1951, § 324, *supra;* now 1954 Code, § 1231(a), (b)(3). The word "gain" is defined by the Code as the excess of the sales proceeds over the accumulated cost or other basis of the property sold. 1954 Code §§ 1001, 1011-1013. Thus, even without a further expression of Congressional intent, a rancher's method of accounting would play an important function in the computation of gain—only those raising expenses that were accumulated instead of being deducted as incurred would be offset against sales proceeds in determining the amount of "gain." The Commissioner had, of course, specifically so ruled as early as 1944. I.T. 3666, *supra.* But Congress was not content to leave such a result to inference. Both the House and Senate Committee Reports to the 1951 legislation (quoted *supra,* p. 14) demonstrate Con-

gress' understanding that the amount of capital gain each rancher would recognize depended on his method of accounting, and Congress' desire that ranchers continue to employ "the method of livestock accounting used * * * and presently recognized by the Bureau of Internal Revenue."

In fact, the next year the Secretary of the Treasury informed Congress that the Commissioner had received a number of requests from ranchers who wished to change from the accrual to the cash method, but that since "the accrual basis now being used by them better reflects their income than the cash basis," the "requests [will] * * * be denied" because they are "not being made for any business reason but solely in order to obtain a tax windfall." (1952 Letter to Congress, R. 13.) Thereafter, Congress declined to amend the Code either to require all ranchers to accumulate the costs of raising breeders or to permit all ranchers to deduct such expenses as incurred. See *supra*, p. 15. Instead, Congress in 1954 reenacted the relevant Code provisions without change.

Thus, we submit (1) that Congress recognized at the time it enacted the 1951 statutory amendment giving capital gain treatment to breeders that cash method ranchers would, because of the necessary simplicity of their accounting system, receive a somewhat greater tax "break" than accrual ranchers; (2) that Congress thereafter refused to eradicate the differential; and (3) that Congress approved the Commissioner's refusal to permit accrual ranchers to switch to the cash method of accounting without a valid business reason.

C. Furthermore, respondents do not, even now, seek to switch from the accrual to the cash method of accounting. They reaffirm their original election of the

more accurate accrual method of accounting and seek to depart from only the aspect of that bookkeeping method relating to breeding animals. Thus respondents are avowedly making no genuine business decision to sacrifice accuracy for simplicity. They are attempting to retain the accuracy of the accrual system of accounting and, at the same time, to obtain the tax advantage which is reluctantly afforded only to those taxpayers who, because of their method of doing business, find simplicity preferable to accuracy. Each method of accounting has its own benefits and burdens. Respondents would combine the advantages of both accounting systems without being subjected to the disadvantages of either. In no event should they be permitted to adopt such a hybrid method of accounting; the Commissioner is not required to accept such a material departure from respondents' over-all accrual method. *Niles Bement Pond Co.* v. *United States,* 281 U.S. 357, 360; *Commissioner* v. *Hansen,* 360 U.S. 446; *Iverson's Estate* v. *Commissioner,* 255 F. 2d 1 (C.A. 8), certiorari denied, 358 U.S. 893; *Banks* v. *Commissioner,* 322 F. 2d 530, 546-547 (C.A. 8); *SoRelle* v. *Commissioner,* 22 T.C. 459.[15]

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[15] There are two additional reasons why the decision of the lower court is wrong as to certain of the respondents:

(1). Both respondents in *Catto* and five of the eight respondents in *Wardlaw* filed their original tax returns for the years in question according to the method of accounting for raised breeders here advocated by the Commissioner (which they had also consistently used in prior years). These respondents later attempted to change their method of accounting for raised breeders retroactively by filing claims for refund. (R. 5, 6, 57-59) Even a permissible change in accounting methods cannot be made after the original return has been filed. *Pacific National Co.* v. *Welch,* 304 U.S. 191, 193-194.

(2). It is evident from the record that the respondents in *Catto* did have an opportunity to change from the accrual to the cash

III.

The Unit-Livestock-Price Variant of the Accrual Method of Accounting Is an Acceptable Method of Computing the Amount of Raising Costs Which Are To Be Deferred Pending Sale of the Animals.

Respondents have at times suggested that the Regulations here in question are invalid because of the way in which they require a rancher who has elected the unit-livestock-price variant of the accrual method of

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method of accounting after it had become clear that breeding cattle were subject to capital gain treatment. Respondent Roxana Catto and her sister inherited two ranches which they operated as a partnership. Between 1948 and 1951 they terminated the partnership and partitioned the lands between respondent Roxana Catto and her sister. Thereafter, Roxana Catto conducted ranching operations on her portion of the land as a sole proprietor. (R. 2).

When (as here) a partnership is dissolved and its business assets divided among the partners, so that each operates a fragment of the old business, the resulting sole proprietorships are sufficiently different from the old partnership's business, to entitle each former partner to elect a new method of accounting. Treas. Reg. § 1.446-1 (d), (e); cf. *J.A. Biewer Estate* v. *Commissioner*, 341 F. 2d 394 (C.A. 6); *Ezo Products Co.* v. *Commissioner*, 37 T.C. 385. See also Treas. Reg. § 1.703-1(b), which regards a partnership as an entity distinct from the individual partners for purposes of electing methods of accounting. Therefore, at the time the Catto partnership terminated and respondent for the first time began business operations as a sole proprietor, she was free to select either the cash or accrual method of accounting. Treas. Reg. § 1.446-1(d). Respondents argued below that a 1945 unpublished letter ruling (1945 CCH Fed Tax Service, vol. 4, para. 6129) precluded them from changing their method of accounting when the partnership was dissolved. That ruling is clearly inapposite. There a sole proprietor accepted a new investor as a partner. Since there was no substantial change in the business, the Commissioner ruled that the partnership could not elect a new method of accounting. In the instant case, the partnership business assets were split between the two sisters and thereafter each carried on a business materially different from the partnership business. Since, at the time the Catto partnership was liquidated, it was clear that profits from

accounting (as have all of the respondents[16]) to defer the costs of raising cattle. In answer to those contentions, we will explain the functioning of the unit-livestock-price method and demonstrate that it is a perfectly acceptable accrual method of accounting for raised livestock and in harmony with the relevant provisions of the Code.

If a rancher elects the accrual rather than the cash method of accounting, he is required by the Regulations to defer the cost of raising his animals and offset the accumulated raising costs against the proceeds received when the animals are sold. Treas. Reg. §§ 1.61-4(b), 1.167(a)-6(b), 1.471-6(f).[17] If a taxpayer were able

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the sale of breeders constituted capital gain, the Catto respondents have been afforded a meaningful choice.

Moreover, similar reasoning may also apply to one of the *Wardlaw* respondents. Although the district court granted summary judgment for the respondents, the record does not contain sufficient facts regarding respondent B. E. Wilson, who apparently entered into a partnership for the first time in 1948 (R. 54), to permit a decision on whether the partnership could at that time have selected the cash method of accounting. See Treas. Reg. § 1.703-1(b).

[16] The Treasury Regulations did not specifically discuss the unit-livestock-price method until 1944. T.D. 5423, 1945 Cum. Bull. 70. However, many ranchers (including the respondents (R. 3-4, 56)) had for many years used the same method—which was then variously called the "constant price" method, the "unit price" method, or the "unit-livestock-price" method. See Mim. 5790, 1945 Cum. Bull. 72. When the Regulations were amended in 1944 to describe the unit-livestock-price method, all accrual taxpayers who had previously been using such a method to report income were required to continue on the unit-livestock-price method. T.D. 5423, *supra;* Treas. Reg. § 1.471-6(h).

[17] Under the accrual method the cost of raising a breeder to maturity, like the costs of building a machine, must be capitalized. However, the costs of maintaining the breeder after it matures and is put into service (such as feed, etc.), like the costs of maintaining and repairing a machine which is in production (*e.g.*, oil, spare parts, etc.), may be deducted as incurred.

to ascertain which costs were incurred with respect to each physical asset produced, he would defer only those incurred with respect to assets still on hand at the end of the tax year and deduct against the proceeds of sale those incurred with respect to assets sold during the tax year. However, in ranching and farming, as in most other industries, it is usually impossible to assign each cost incurred to a particular physical asset. Therefore, an estimated-cost approach is usually employed. The key to such a system is the valuation of assets (here cattle) on hand at the end of the tax year. If realistic estimates are used, an estimated-cost system should reach the same result as an actual cost method without requiring extensive and complex record-keeping devices.

The "unit-livestock-price" method is just such an estimated cost system designed especially for livestock raisers. If a taxpayer elects to use the "unit-livestock-price" method, he estimates the amount it costs him to raise his different types of livestock to various stages of development and establishes a "standard unit price" for each age level of a particular class of livestock. Treas. Reg. § 1.471-6(e). At the beginning of the year in which the rancher first adopts unit pricing, he counts the number of head on hand in each class and values them according to his established estimates (which will remain constant from year-to-year unless there is a sharp rise in costs). This is his opening inventory. At the end of the year he similarly counts and values his livestock on hand to arrive at closing inventory (which, of course, will also be opening inventory for the succeeding year). Treas. Reg. § 1.471-6(f); Mim. 5790, 1945 Cum. Bull. 72. The rancher then computes his income for a given year as follows: Opening in-

ventory represents raising costs incurred in previous years but not deducted because allocable to animals which were still on hand at the end of the previous year (*i.e.*, the beginning of this year). The total of opening inventory and the raising expenditures incurred during the current tax year represent costs incurred by the taxpayer (both that year and in previous years) but not yet deducted. Closing inventory represents the costs which are to be deferred until later tax years because allocable to animals still on hand at the year end. Therefore, the total of opening inventory and raising expenses incurred during the current year less closing inventory equals the amount of costs allocable to animals sold during the year in question. This amount is deducted from gross income. Treas. Reg. §§ 1.61-4(b), 1.162-12.

For an illustration of how this method works, assume that a livestock raiser estimates that it costs him $10 per year to raise an animal to maturity. Suppose that at the beginning of the year he had on hand 10 one-year-olds. His opening inventory would therefore be valued at $100. Assume, also, that he expended $100 in raising these animals during the year and sold none of them. Therefore, at the year's end the rancher would have incurred a total of $200 of expenditures which he had not yet deducted: $100 spent in the current year, plus $100 spent in previous years and deferred because the cattle had not yet been sold. His closing inventory would be $200 (10 × $20), and his gain or loss for the year would be computed as follows:

Sales		$0
Costs of Goods Sold:		
Opening inventory	$100	
Expenditures for feed, etc.	$100	
	200	
Less: Closing inventory	200	
		$0
Profit		$0

Thus, to the extent the taxpayer estimates that his cattle on hand at the end of the year cost him more than the cattle he had on hand at the beginning of the year, his raising costs incurred during the year are deferred. To this extent his costs are accumulated in the closing inventory account and carried forward as the cost basis of the goods on hand for the succeeding year (*i.e.*, opening inventory for the next year is $200).[18]

Expenditures incurred in raising breeders are almost identical in kind to those incurred in raising beef cattle; in fact the two classes of livestock are usually kept in the same herd until a certain age is reached. It is virtually impossible to separate the costs incurred with respect to breeding animals from the general pool of raising expenditures. Consequently, the Regulations

[18] The Regulations explain the mechanics of computing income somewhat differently than stated above. However, the result is the same. The Regulations state that the taxpayer should add closing inventory to income and subtract both opening inventory and expenditures incurred during the year. Treas. Reg. §§ 1.61-4(b), 1.162-12. This, of course, reaches exactly the same result explained above: It reduces the deduction for expenditures incurred during the year by the increase in inventory, *i.e.*, by the amount of the expenditures which has been accumulated in inventory and deferred until the animals are sold.

require ranchers who use the unit-livestock-price method of deferring the costs of raising beef cattle to apply the same method to their breeding animals. Treas. Reg. § 1.471-6(f). As a practical matter this generally means that a taxpayer includes his raised breeders in his inventory.[19] This procedure does not, however, prevent the rancher from reporting the gain on sale of breeders as capital gain; it merely requires that he use the unit-livestock-price method of estimating the amount of raising costs which will be deferred and deducted against sales proceeds in computing gain. In fact, the Commissioner ruled as early as 1944 that a rancher is entitled to capital gain on sales of breeders regardless of how he computes their cost basis and regardless of whether he includes them in inventory for accounting convenience.[20] I.T. 3666, 1944 Cum. Bull. 270.

Respondents have argued that the Regulations are invalid because they require an accrual method rancher to add increases in the inventory value of breeders to ordinary income. As explained, *supra*, p. 29, fn. 18, the requirement that closing inventory be added to income and opening inventory be subtracted from income must be viewed along with the requirement that raising expenses incurred during the year also be deducted from income. See Treas. Reg. §§ 1.61-4(b), 1.162-12. The net effect of these three steps is to defer the ex-

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[19] While the Regulations do not require him to include raised breeders in inventory, at least one ruling assumes that he will do so. Mim. 5790, 1945 Cum. Bull. 72.

[20] Indeed, although given a choice by the Regulations (Treas. Reg. §§ 1.471-6(g), 1.61-4(b)), a number of the respondents made a binding election to include their *purchased* breeders in inventory for accounting convenience (R. 105-106).

penses incurred that year to the extent inventory has increased and permit an immediate deduction of only the excess.[21] So viewed, it is clear that these mechanics do not deprive respondents of any capital gain; they merely result in deferral of the costs properly allocable to breeding cattle so that these costs may be deducted against the proceeds from the sale of such animals.

Assume, for example, that the estimated cost of a rancher's beef and breeding cattle on hand at the beginning of the year was $100, that he expended $100 in raising those animals during the year, and that the estimated cost of his unsold cattle at the end of the year was $140. Since his inventory increased by $40, it means that $40 of the $100 expended during the year had been deferred, *i.e.*, added to the cost basis of beef and breeding cattle on hand at the end of the year. The other $60 represents the costs of raising the cattle which were sold, and is accordingly to be deducted from the proceeds of sale to determine gain, capital or ordinary depending on whether the animals sold were breeding or beef cattle. Internal Revenue Code of 1954, §§ 1001, 1011-1013, 1016.[22]

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[21] The stipulation of facts in the *Wardlaw* case recognizes that this is the actual effect of the mechanics explained in the Regulations (R. 67-68).

[22] In practice, the inventory mechanics differ slightly with respect to beef and breeding cattle. Since opening inventory includes both beef and breeding animals and since opening inventory is in effect deducted from ordinary income to compute ordinary gain, those breeders which have been sold must be removed from opening inventory in order to avoid a double deduction: Once in computing the amount of capital gain and again in computing ordinary income. *Gibbs* v. *Commissioner*, 33 T.C. 27; *Little* v. *Commissioner*, 34 T.C. 156, affirmed, 294 F. 2d 661 (C.A. 9). See also R. 68.

Therefore, the Regulations merely require taxpayers who have chosen the unit-livestock-price method of valuing their inventory of beef cattle, to employ the same method in valuing their breeding cattle, *i.e.*, to use the same method in deciding the amount of costs to be deferred rather than deducted with respect to breeding as well as beef cattle. Treas. Reg. 1.471-6(f). When a breeder is sold, the excess of the sales proceeds over the animal's deferred cost basis will, of course, constitute capital gain. Thus, the unit-livestock-price method is merely a way of estimating the amount of the expenditures which will be deferred—both with respect to beef and breeding cattle—and does not affect the rancher's right to capital gain on the sale of breeders.[23] A procedure

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[23] In general the Treasury Regulations permit accrual basis ranchers to depreciate either purchased or raised breeding cattle used in their trade or business. Beginning with a breeding animal's maturity a rancher, under generally accepted principles, is permitted to depreciate the excess of its cost basis over its estimated salvage value. Treas. Reg. §§ 1.61-4(b), 1.167(a)-6(b). However, because breeding animals can be sold for their beef value at the end of their useful lives as breeders, the cost of raising a breeding animal almost always approximates or is less than its estimated salvage value. This is especially true of those taxpayers who use the unit-livestock-price method of valuing their cattle; standard unit costs (used to value cattle on hand) have remained constant over the years while actual costs and salvage values have risen because of inflation. Thus as a practical matter only purchased breeders (for which thousands of dollars are sometimes paid) are depreciable, and raised breeders (for which at most a few hundred dollars of raising costs are expended) are not. This explains the ruling which prohibits a rancher who elected the unit-livestock-price method of accrual accounting from depreciating his raised breeders. I.T. 3712, 1945 Cum. Bull. 176; Mim. 5790, 1945 Cum. Bull. 72. Cf. Treas. Reg. 1.61-4(b). The prohibition merely prevents him from depreciating raised breeding cattle, which as a practical matter he could not have depreciated anyway, and has no other effect. In any event, none of the respondents seeks to depreciate raised breeders.

which is a proper means of deferring the costs of producing beef cattle cannot be inappropriate when applied to breeding cattle for the same purpose.

CONCLUSION

The judgments of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954:

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * * *

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 446.)

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * *.

(26 U.S.C. 1001(a).)

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided * * *

(26 U.S.C. 1012.)

SEC. 1013. BASIS OF PROPERTY INCLUDED IN INVENTORY.

If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

(26 U.S.C. 1013.)

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account * * *

(26 U.S.C. 1016.)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * *

(b) *Definition of Property Used in the Trade or Business.*—For purposes of this section—

* * * *

(3) *Livestock.*—Such term also includes livestock, regardless of age, held by the tax-

payer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(26 U.S.C. 1231.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.61-4 *Gross income of farmers.*

(a) *Farmers using the cash method of accounting.* A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits

shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). * * *

(b) *Farmers using an accrual method of accounting.* A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in sub-paragraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in sub-paragraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for

draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471. * * *

(c) *Special rules for certain receipts.* In the case of the sale of machinery, farm equipment, or any other property (except stock in trade of the taxpayer, or property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), any excess of the proceeds of the sale over the adjusted basis of such property shall be included in the taxpayer's gross income for the taxable year in which such sale is made. * * *

* * * *

§ 1.162-12 *Expenses of farmers.*

A farmer who operates a farm for profit is entitled to deduct from gross income as necessary

expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. * * * Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with § 1.61-4. * * *

* * * *

§ 1.167(a)-6 *Depreciation in special cases.*

* * * *

(b) *Depreciation in cases of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. * * *

* * * *

§ 1.446-1 *General rule for methods of accounting.*

* * * *

(e) *Requirement respecting the adoption or change of accounting method.* * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

* * * *

§ 1.471-6 *Inventories of livestock raisers and other farmers.*

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit

prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market, whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, *Petitioner*

V.

JOHN CATTO, JR. and ROXANA CATTO

on writ of certiorari to the United States Court of Appeals for the Fifth Court

BRIEF FOR JOHN CATTO, JR. AND ROXANA CATTO

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BRIEF FOR JOHN CATTO, JR. AND ROXANA CATTO

OPINION BELOW

The district court did not file an opinion. Its findings of facts and conclusions of law in *United States v. Catto* (R. 34-41), are reported at 223 F. Supp. 663. The *per curiam* opinion of the court of appeals is reported at 344 F. 2d 227.

JURISDICTION

The judgment of the court of appeals was entered on April 8, 1965 (R. 49). Mr. Justice Black extended the time for filing a petition for a writ of certiorari to and including September 5, 1965, (R. 108-111). The petition for a writ of certiorari was filed on September 3, 1965, and granted on November 22,

1965 (R. 112). This Court has jurisdiction under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Section 1231 of the Internal Revenue Code of 1954, which permits capital gain treatment on property used in the trade or business, provides that livestock, regardless of age held by the taxpayer for draft, breeding, or dairy purposes and held for more than 12 months, are property used in the trade or business which is subject to the allowance for depreciation and is not properly includable in inventory. Treasury Regulation §1.471-6(f) on the other hand provides in part that a taxpayer who uses the "unit-livestock price method" of valuing inventory must include all livestock raised whether for sale or for draft, breeding or dairy purposes, in inventory. The questions present are:

(1) Whether Treasury Regulation §1.471-6 (f), requiring taxpayers to include raised livestock held for draft, breeding or dairy purposes in inventory, is contradictory to the provisions of Section 1231 of the Internal Revenue Code of 1954 and invalid and of no force and effect?

(2) Whether, the taxpayers, without the consent of the Commissioner of Internal Revenue and in order to correct an error caused by the Commissioner's own regulation, are entitled to remove from inventory raised breeding livestock erroneously included in inventory in compliance with the Treasury Regulation?

(3) Even if a change of accounting method is involved, does the law require a taxpayer to do a use-

less thing by applying to the Commissioner for permission to change a particular item when the facts show that the Commissioner would have refused to consider and act upon such application?

STATUTES AND REGULATIONS INVOLVED

Sections 446(e), and 1231, (a), (b)(1) and (b)(3) of the Internal Revenue Code of 1954, and Sections 1.61-4, 1.162-12, 1.446-1(e) (2)(i), and 1.471-6 of the Treasury Regulations (1954 Code), appear in the Appendix, *infra*, pp. 35-45.

STATEMENT

The taxpayers in the Catto case are ranchers engaged in the business of breeding and raising cattle for the production and sale of calves. In connection therewith they maintain a breeding herd. As circumstances require they add thereto, purchase bulls and cows and selected calves raised by their breeding herd. (R. 2-4).

When the taxpayers commenced their ranching business in 1938 they adopted the accrual (inventory) method of accounting and used the unit-livestock-price method of valuing inventory. In accordance with the applicable Treasury Regulations[1] taxpayers included raised breeding cattle in inventory, whether held for sale or for draft breeding or dairy purposes. As a result of being compelled by these Regulations to include raised breeding animals in inventory, the taxpayers were forced to include in their ordinary income

[1] Reg. 111, §29.22(c)-6; Reg. 118, §39.22(c)-6(f); Reg. §1.471-6(f) promulgated under the 1954 Code.

the initial inventory value of their raised breeding animals and thereafter the annual increases in inventory values assigned to such animals, including the taxable years, 1954 and 1955, here involved. On the other hand, in the years in which such animals were sold, the amount of profit from the sale that was entitled to capital gain treatment under Section 1231, and its predecessor, Section 117(j), was reduced because taxpayers were required to deduct, as the cost basis, the accrued inventory value from sales price in order to compute the profit to which the capital gain rate would apply. (R. 3-5).

Ranchers who use the cash receipts and disbursement method of accounting are not compelled by the Treasury Regulation to maintain an inventory and include in their ordinary income values for their breeding animals. Thus, such taxpayers are permitted to deduct the cost of raising breeding animals ordinary income and to compute their capital gain on the sale of such animals on a zero basis. (R. 7).

After the decision in *Scofield* v. *Lewis*, 251 F 2d 128 (C.A.5), taxpayers filed a claim for refund claiming that Treas. Reg. §1.471-6(f) was contradictory to Section 1231 of the Code, and therefore, invalid and of no force and effect; and that they were entitled to correct the error caused by the invalid Regulation. Prior to filing such claim, taxpayers did not request the Commissioner's permission to change from the accrual to the cash method. However, it was stipulated that the Commissioner, during such years, would not consider such a request. Taxpayers claim was never rejected nor paid and after the expiration of six

months taxpayers sued for a refund and the district court rendered a judgment in their favor. The Fifth Circuit affirmed *per curiam* on the authority of its earlier decision in *Scofield* v. *Lewis, supra,* and, held that the Treasury Regulation which compelled the taxpayer to include raised breeding animals in inventory was invalid and that the taxpayers were entitled to correct the error caused by the Regulation without the Commissioner's consent. (R. 6-8, 43, 46-48).

STATEMENT OF POINTS TO BE URGED

I. The Treasury Regulation requiring an accrual (inventory) basis livestock raiser valuing inventory under the unit-livestock-price method to include raised breeding animals in inventory is contradictory to Section 1231 of the Internal Revenue Code of 1954, and invalid and of no force or effect.

II. Taxpayers are entitled to correct the error caused by the invalid Treasury Regulation and remove from inventory raised breeding animals included in inventory in compliance with the Regulation. Correction of the error does not constitute a change of accounting method, and therefore, taxpayers are not required to obtain the consent of the Commissioner of Internal Revenue.

III. Even if a change of accounting method is involved, the law does not require a taxpayer to do a useless thing by applying to the Commissioner for permission to change a particular item when the facts show that the Commissioner would have refused to consider and act upon such application.

INTRODUCTION

The approach utilized in the Government's brief proceeds on the theory, however well disguised, that regulations affecting inventory can be used as tools to defeat legislative and judicial intent. It will be demonstrated in this brief that this is entirely consistent with the effort, made unremittingly since the enactment of Section 117(j) in 1942, to defeat the application of capital gains treatment to the livestock industry. Initially commencing as an effort to deny its benefits entirely, then retreating step by step in attempts to circumscribe its application by restrictive devices, the assault has here reached a climax through an attempt to discriminate against a segment of the livestock industry through an inventory device which plainly and explicitly is contrary to express statutory language.

A number of basic misconceptions are employed in the rationale of the Government's brief. An understanding of these fallacies is essential to a clear comprehension of the appropriate solution of the issues here presented. For example:

A. The regulation involved *did not* have its genesis in 1924. Regulations then promulgated and cited by the Government do not relate to the unit-livestock-price method of valuing inventory. The regulation involved (Treas. Reg. 1.471-6[f]) was first issued in 1944. Thus, some two years *after* Section 117 (j) was enacted, the Treasury spoke for the first time in setting forth requirements that *breeding animals* must be included in inventory if the taxpayer uses the unit-livestock-price method to value inventory.

B. There is no committee report, no Congressional Record and no other publication which gives any indication that the Congress or any Committee thereof ever dealt specifically with Regulations requiring the inclusion of breeding livestock in an inventory. There is not the slightest hint that in dealing with the issues of livestock and capital gains in 1951 and in 1954, the Congress was even aware of any distinction between cash and accrual basis taxpayers. Indeed the record reflects a preoccupation with the broad capital gains issue in the livestock industry rather than with the niceties of accounting systems, inventory practices and the like. For one to conclude that a Committee of Congress, engrossed in the consideration of broad general concepts of taxation and the applicability of capital gains in a given area, is simultaneously aware of and considering minute and peripheral issues relative to inventory methods, is to ascribe to its members an all-encompassing intent which would appear to be at variance with any rational analysis of their though processes. Indeed, as will be demonstrated, the doctrine of legislative re-enactment has no application unless the Committee verbally or in committee reports indicated familiarity with the subject matter. No such familiarity has been demonstrated here.

C. The premise in the government's brief (Br. 21) that the Commissioner, "as a matter of policy, denied . . . requests" for a change in a method of accounting, is completely inaccurate and contrary to the record. It has been stipulated (R. 7-8) that the Commissioner would have refused to consider, and as a consequence to act upon, such an application. Hence, in

addition to the point strenuously asserted in the body of this brief that a change of accounting method was not involved, it is a hollow mockery to require taxpayers to file a request which would not even be considered and then to indulge in lengthy philosophical discussions about the relative merits and demerits of what might have been contained in the request. The law simply does not require a taxpayer to do a useless thing.

D. The contention is made in the Government brief that in 1951 the situation with reference to breeding livestock and its tax treatment was simplicity itself and clear cut is the extreme. Congress is supposed, in that year, to have "codified" the law (Gov't Br. p. 22). Thus, the argument goes, Respondents had a meaningful choice in 1948 and 1951. Yet *in the very* year, 1951, we find the Government asserting in *United States* v. *Bennett*, 186 F.2d 407, (C.A. 5), that all livestock are necessarily held primarily for sale. Clear and meaningful choice? Of course not!

Other fallacious premises in the Government's position will not here be delineated. Rather, we now proceed with a discussion of the issues.

ARGUMENT

I.

THE TREASURY REGULATION REQUIRING AN ACCRUAL (INVENTORY) BASIS LIVESTOCK RAISER VALUING INVENTORY UNDER THE UNIT - LIVESTOCK - PRICE METHOD TO INCLUDE RAISED

BREEDING ANIMALS IN INVENTORY IS CONTRADICTORY TO SECTION 1231 OF THE INTERNAL REVENUE CODE OF 1954, AND INVALID AND OF NO FORCE OR EFFECT.

A. *The Government Has Consistently Refused To Grant Livestock Raisers The Full Benefit of Capital Gain Treatment.*

The predecessor of Section 1231 of the Internal Revenue Code was enacted by Congress in 1942 when Section 117(j) was added to Internal Revenue Code of 1939.[2] By enactment of Section 117(j), Congress extended capital gain treatment to gains derived from the sale or exchange of certain property used in a trade or business. As originally defined, the term "property used in the trade or business" meant property with these characteristics:

(1) Property used in the trade or business.
(2) Property of character which is subject to to the allowance of depreciation.
(3) Property which was held for more than six months.
(4) Property which was not of a kind which would properly be includable in the inven tory of the taxpayer if on hand at the close of the taxable year.
(5) Property which was not held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

[2] Section 117(j) was added by Section 151(b) of the Revenue Act of 1942, c. 619, 56 Stat. 798.

The Statute made no distinction between the cash and accrual basis taxpayers. Thus, under qualifying circumstances, its favorable treatment was available to cash and accrual basis taxpayers alike.

While the original definition of property used in a trade or business contained no specific reference to livestock, livestock raisers began to claim capital gain treatment on breeding stock sold at the expiration of its usefulness in the breeding herd since such livestock had all the characteristics of such property. The Commissioner of Internal Revenue from the outset attempted to limit and deny the benefits of the new section to breeding stock.[3] However, the Courts uniformly struck down the Commissioner's unfounded attempts to withold from breeding herd owners the capital gain treatment afforded by Section 117(j).

In *Albright* v. *United States*, 173 F. 2d 339 (C. A. 8), decided on March 10, 1949, the Eighth Circuit, reversing the Government, held that a cash basis dairy farmer, maintaining his herd at normal size throughout the taxable year, was entitled to capital gain treatment on his regular sale of excess or worn out animals from the herd under circumstances where the other statutory requirements were met. The Court specifically held that the Commissioner's administrative rulings attempting to limit and restrict the application of Section 117(j) were invalid.[4]

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[3] I.T. 3666, 1944 Cum. Bull. 270; I.T. 3712, 1945 Cum. Bull. 176; and Letter of Commissioner, Aug. 4, 1947 (1948 C.C.H. 6091), as citde in Albright v. United States, supra, 173 F. 2d 339, 343 (C.A. 8).

[4] June 27, 1949, the Tax Court of the United States, on the authority of Albright, supra, gave the same treatment to a cash basis dairy farmer. Emerson v. Commissioner, 12 T.C. 875.

After it became apparent that the claim of cash basis livestock raisers to capital gains treatment could not be defeated, the Commissioner directed his attack in denying capital gain treatment to accrual (inventory) basis livestock raisers. In *Fawn Lake Ranch* v. *Commissioner*, 12 T.C. 1139, appeal dismissed 180 F. 2d 749 (C.A. 8), the Tax Court held that accrual basis livestock raisers were entitled to the benefits of Section 117(j).[5]

Despite these repeated set-backs the Commissioner elected to stubbornly and relentlessly continue his fight to limit the benefits of Section 117(j) to the livestock industry. He suffered his next major defeat in *United States* v. *Bennett*, 186 F. 2d 407, decided on June 8, 1951, where the court rejected the Government's contention that all livestock are held primarily for sale and ruled that culls, sold out of a cash basis taxpayer's breeding herd, were entitled to Section 117(j) treatment.

The Commissioner, however, proceeded to fight on. In Mim. 6660, 1951-2, Cum. Bull. 60, it was announced that prior administrative rulings would be revoked in the light of the *Albright* and similar decisions, but for the first time the Commissioner arbitrarily stated that capital gain treatment would be denied on sales of younger animals which were not used as breeders for substantially their full lives.

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[5] The Tax Court pointed out that breeding herd animals were not properly includable in inventory and the fact that such animals had been included in inventory could not defeat the taxpayer's claim to capital gain treatment, since their inclusion was in compliance with the Commissioner's ruling, 12 T.C. at p. 1144.

As a result of the Commissioner's unfounded attempt to qualify and limit the *Albright* and similar decisions, Congress amended Section 117(j) by adding thereto Section 324 of the Revenue Act of 1951, c. 521, 65 Stat. 452. The amendment made the Section specifically applicable to livestock, regardless of age, held by taxpayer for draft, breeding, or dairy purposes and held for 12 months or more from the date of acquisition.[6] Thereafter, the Commissioner revoked Mim. 6660, see Mim. 6776, 1952-1 Cum. Bull. 71. However, even after the enactment of the amendment to Section 117 (j) the Commissioner *unsuccessfully* attempted to impose new standards of age and reproductive capacity on the sales of young animals by livestock raisers. *McDonald* v. *Commissioner*, 214 F.2d 341 (C.A. 2)

The instant case clearly demonstrates that the Commissioner has not elected to abandon his stubborn and relentless attack to deny the *full benefit* of capital gain treatment to members of the livestock industry.

B. *The Treasury Regulation Results In Discrimination Against These Taxpayers.*

There can be no question that, as the result of the amendment to Section 117(j) and the re-enactment of that Section as Section 1231 of the Internal Revenue Code of 1954 applicable to the years in issue, breeding herd animals, regardless of age, are property used in a trade or business subject to the allowance for deprecia-

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[6] The amendment to Section 117(j) was made applicable with respect to taxable years beginning after December 31, 1941, except that the extension of the holding period from 6 to 12 months was made applicable only with respect to taxable years beginning after December 31, 1950.

tion and *not properly includable in inventory.* Treasury Regulation §1.471-6(f) promulgated under the 1954 Code, however, requires a taxpayer who uses the unit-livestock-price method in valuing inventory to apply it to all livestock raised, whether they are raised for sale in the ordinary course of business or for inclusion in the breeding herd, thereby compelling the inclusion of raised breeding herd animals in inventory at a unit value.[7]

It would appear to be elementary that a regulation which directly contravenes the plain and unambiguous terms of a statute is invalid and no force and effect. The statute in question clearly states that raised breeding animals are not properly includable in inventory; the Regulation, however, requires that such animals must be included in inventory.

The net effect of the Regulation in question is to discriminate against accrual basis ranchers, such as these taxpayers, who use the unit-livestock-price method to value their inventory. Ranchers who use the cash method are not compelled by the Regulations to maintain an inventory and include in their ordinary income values for breeding animals.[8] Such ranchers, as are all ranchers, are permitted to deduct the cost connected with raising livestock. Treas. Reg. §1.62

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[7] This Regulation was originally issued in December, 1944, T.D. 5433, 1945 Cum. Bull. 70, as an amendment to Treas. Reg. 111, §29.22(c)-(6), and was carried forward in Treas. Reg 118, §38.22(c)-6(f) issued in 1953 and applicable to the taxable years beginning after 1951.

[8] Similarly, accrual (inventory) basis taxpayers who use the farm-price method of valuing inventories, are not compelled to include their raised breeding animals in inventory. Treas. Reg. §1.61-4, 1.471-6(d).

-12.[9] Thus, the cash basis rancher is entitled to carry raised breeding animals at a zero basis, and when such animals are sold, capital gain treatment is permitted on the entire sales price.

While the accrual basis rancher using the unit-livestock-price method is entitled to deduct the cost of raising livestock, the Commissioner offsets the benefit of such deduction by requiring him to include raised breeding livestock in inventory at a unit value, along with his livestock held primarily for sale, and to increase the unit value until the livestock reaches maturity. By adding these unit values to inventory and annually increasing such values, the rancher's ordinary income is increased, and the Commissioner thereby effectively offsets the deduction for raising costs. When such livestock is sold, the rancher must deduct the unit values from the proceeds of the sale. Thus, the Regulation increases the accrual basis rancher's ordinary income and limits his right to capital gain.

A simple example clearly demonstrates the discriminatory effect of the Commissioner's Regulation:

> A, a cash basis rancher, raises a cow for his breeding herd at a cost of $35.00. He is permitted to deduct the cost of raising the cow against ordinary income, but he is not compelled by statute or regulation to include the value of the

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[9] The right was originally granted in 1921 by Reg. 45, Art. 110. The deduction is, and has been granted to all livestock ranchers, regardless of whether they are on the cash or accrual method and regardless of what method of valuation they use. See Letter of June 27, 1952, from Secretary of the Treasury to Chairman of the Senate Finance Committee, 98 Cong. Rec., Pt. 6, pp. 8307-8308 (R. 9-15), herein referred to as Letter From Secretary of Treasury.

cow in inventory and increase his ordinary income. When she is five years old he sells her for $100.00. The Commissioner concedes that under the statute and regulations that A is entitled to capital gain on the entire $100.00.

B, an accrual basis rancher who uses the unit-livestock-price method to value his inventory, also raises a cow for his breeding herd at a cost of $35.00. He is also permitted to deduct the cost of raising the cow but he is compelled by the Regulation to include the cow in inventory at $35.00. Thus, he is required to include the $35.00 in ordinary income and pay ordinary income tax thereon. When B's cow is five years old, B sells her for $100.00. Under the Government's contention in this case and the Regulation, B gets capital gain treatment only on the difference between $35.00 (inventory value) and $100.00 (selling price) or $65.00.

Thus, by the benign device of forcing raised breeding animals in inventory, along with animals held primarily for sale, the Commissioner has converted into ordinary income what would otherwise, if the rancher was on the cash basis, be taxed as capital gain. As a consequence, the Regulation discriminates against the accrual basis taxpayer who uses the unit-livestock-price method to value inventory. In doing so, the Regulation violates the clear intent of Congress in enacting Section 117(j) in that:

> "Section 117(j) was intended as a relief measure *applicable alike* to all taxpayers within its

provision, *Leland Hazard* v. *Commissioner*, 7 T.C. 372. That it was so intended is clearly expressed in the report of the Committees of the House of Representatives and the Senate in charge of the bill See H. Rep. No. 2333, 77th Cong., 2d Sess, pp. 53-54 (1942-2 Cum. Bull. 372, 415), and S. Rep. No. 1631, 77th Cong. 2d Sess., p. 50 (1942-2 Cum. Bull. 504, 545)." *Albright* v. *United States*, 173 F. 2d 339, 344 (emphasis added).

It was not, therefore, surprising when the court of appeals struck down the Regulation as invalid and in conflict with the statute in *Scofield* v. *Lewis*, 251 F. 2d 128. The court there stated at page 132:

> " . . . The Regulations must, by their terms and in their application, be in harmony with the statute. A Regulation which is in conflict with or restrictive of the statute is to the extent of the conflict or restriction, invalid. A Regulation valid when promulgated, became invalid upon the enactment of a statute in conflict with the Regulation. The only authority conferred, or which could be conferred, upon the Treasury Department is to make regulations to carry out the purposes of the statute. *Miller* v. *United States*, 294 U.S. 435, 55 S. Ct. 440, 79 L. Ed. 977, rehearing denied 294 U. S. 734 55 S. Ct. 635, 79 L. Ed. 1262; *Newman* v. *Commissioner*, 5 Cir., 1935, 76 F. 2d 449 certiorari denied 296 U.S. 600, 56 S. Ct. 116, 80 L. Ed. 425."

When Congress determined that breeding animals were property used in trade or business and, therefore, that the gain on their sale was capital gain, it became necessary to distinguish between animals held for sale and animals held for breeding purposes. At that time, it became improper to include animals held for breeding purposes in inventory.[10] At that time it became incumbent upon the Commissioner to change the Regulation. However, he has consistently refused to do so. His refusal, we submit, is but another of his unyielding efforts to limit and deny capital gain treatment to the livestock industry, and to frustrate judicial construction and Congressional intent which made Section 117(j), and its successor Section 1231, "applicable alike to all taxpayers within its provisions."

C. *Congress Has Not Approved The Discriminatory Effect of The Regulation.*

The Government attempts to justify the discriminatory effect of Treasury Regulation §1.471-6 (f), and its predecessors, by asserting that Congress intended to approve the disparity which existed between cash and accrual basis taxpayers who use the

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10 Subsequent to the authorization of capital gains on breeding livestock, the distinction in treatment between animals held for breeding purposes and animals held for sale is in itself entirely reasonable. Under the accounting theory of the accrual method, animals held primarily for sale to customers do, in fact, increase in value each year as they add weight and maturity. Therefore, the accrual basis taxpayer accurately reflects income by including therein the estimated increase in such value each year, thereby securing the advantage of "averaging" his income over the years during which animals are held. On the other hand, animals held for breeding purposes in fact decline in value to the owner each year they are so used. Their main value is as breeders and normally they are not sold until some event occurs which diminishes their value as breeders. Thus, increased weight and maturity are largely meaningless to the owner of a breeding herd, and no income is actually realized, even in the accrual basis concept of that term, until the year in which they are sold.

unit-livestock-price method to value inventory when it enacted the amendment to §117(j) in 1951 (Br. 14-15). The Government argues that Congress, in effect, froze such discriminatory treatment into law by precluding a change in the cash method of accounting. This argument is totally lacking in vitality. The Committee Reports referred to by the Government [11] do not reflect any consideration whatsoever of the effect of the amendment on cash or accrual basis taxpayers, or that Congress was even aware of the disparity in treatment between the methods. Further, the Reports do not reflect Congress was aware that the disparity in treatment was caused by the Commissioner's Regulation which compels the inclusion of breeding livestock in inventory. The Committee simply did not have the question before it. It is clearly apparent from the Reports that Congress was concerned with only one consideration, namely, to specifically authorize capital gain treatment for livestock used for draft, breeding or dairy purposes, and to thwart the Commissioner's continuing unfounded attempts to limit and deny capital gains to the livestock industry.

In the same vein the Government argues that the legislative history (Letter from Secretary of Treasury) and the statutory re-enactment of the provisions for breeding cattle "verbatim" in the 1954 Code (as §1231) prevented the Treasury Department from amending the regulations relating to cash method ranchers and also gave effect of law to the regulations re-

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[11] S. Rep. No. 781, 82d Cong., 1st Sess. p. 42; H. Rep. No. 586, 82d Cong., 1st Sess., p. 32.

lating to accrual method ranchers.[12] The Government's argument is predicated on the erroneous assumption that the Secretary of Treasury's letter has probative value as legislative history.[13] The letter's only claim to fame is that it was introduced in the Congressional Record. However, it was introduced on a day when the Senate was not considering problems of Federal income taxation and it was introduced without comment. The Government has made no showing whether or not the letter was even considered by the Senate or House of Representatives as a whole or in committee. The letter nowhere even mentions or makes reference to the fact that the Commissioner by

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[12] The same argument is advanced by the Government in support of its contention that Congress approved the Commissioner's refusal to permit accrual ranchers to switch to the cash basis (Br. 23). It is equally erroneous and untenable for the reasons set forth in the brief.

[13] The Government's argument also assumes that the so-called "Rule of Statutory Re-enactment" has validity today. In **Mertens**, Law Federal Income Taxation, Vol 1, §3.24, pp. 45-52, the rule is characterized as:

> "an anachronism left over from earlier days in which statutes were briefer, were seldom reenacted or amended, and where administrative interpretation was far simpler. In income tax matters where in early years there was a new revenue act at least every two years, then a codification in the 1939 Code, continuing new revenue acts and finally the total rewritten 1954 Code, and with the Board, the Tax Court, and the district and circuit courts often issuing conflicting decisions, the policy of administrative interpretation is often based on the principal of expediency. In this area it is obvious that the ordinary presumption as to Congressional familiarity with administrative interpretation is an archaic fiction."
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> "In complex income tax law it is absurd to indulge in the fiction that the full import of Treasury Regulations and administrative practice is known to the members of Congress . . . As the Supreme Court said in the case of Helvering v. Hallock: . . . 'we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principal.' . . . The fallacy in the frequently expressed rule that reenactment of a statute gives the force of law to prior interpretation is that it is unreasonable to assume that Congress was familiar with such interpretation unless it verbally or in committee reports indicated familiarity with such interpretation."

his regulations was requiring taxpayers who use the unit-livestock-price method to include their raised breeding animals in inventory.[14] The letter merely discusses cash and accrual methods of accounting and the situation as to farmers and ranchers under the two accounting methods. Thus, the unit-livestock-price method, a method of inventorying livestock, is not the subject matter of discussion in the letter at all. Certainly the letter cannot be regarded as apprising Congress in most thorough and clear terms of the way the Commissioner was administering the law regarding livestock held for breeding purposes.

It would seem to be equally arguable that had Congress known the reason for the inequity was the regulation requiring the inclusion of raised breeding livestock in inventory by users of the unit-livestock-price method, the inequity would have been corrected. Thus, equally as reasonable as the Government's conclusion is the conclusion that because Congress was unaware of the basic cause of the inequity, its failure to take action to cure it is meaningless. *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431; *Commissioner* v. *Wilshire Oil Co.*, 95 F. 2d 971 (C.A. 9), reversed on other grousds, 308 U.S. 90; *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 468.

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[14] In all probability, Congress was unaware of the requirement of Reg. §1.471-6(f) where it re-enacted §117(j) as amended as §1231 of the 1954 Code. The Regulation concerns itself not with capital gains but with inventory methods. From a standpoint of physical arrangement within the Regulations themselves, it is far removed from the provisions relating to capital gains. Furthermore, where the Internal Revenue Code was adopted, the Code alone comprised over 1000 pages, and the Treasury Regulations were several times this length. Thus, it is unreasonable to assert that Congress, with its membership changing continuously over the years, knew the full import of all Treasury Regulations when the Internal Revenue Code of 1954 was enacted.

The cases cited by the Government (*Helvering* v. *Winmill*, 305 U.S. 79; *Corn Products Co.* v. *Commissioner*, 350 U.S. 46; *Lykes* v. *United States*, 343 U.S. 118; *Helvering* v. *Reynolds Co.*, 306 U.S. 110; Br. 16) in support of the proposition that Congressional inaction to the Treasury's request indicates a Congressional intent to leave the situation as it existed further demonstrates the fallacy of the Government's argument. Those cases involved situations wherein a statute was enacted, later an administrative interpretation of the statute was issued, and thereafter the same provisions of the statute were re-enacted by Congress. Thus, in those cases we find the court quite reasonably holding that the re-enactment constituted legislative approval of the administrative interpretation.

In this case, however, the facts and sequence of events were definitely not the same as in the cases cited by the Government. Here, in 1945, the Commissioner issued a regulation requiring accrual basis taxpayers using unit-livestock-price method to include *all* animals in inventory. In 1951, Congress amended Section 117(j) to specifically include livestock. The 1954 Code re-enacted the relevant provisions of the 1951 amendment. A regulation followed by the amendment of a statute directly in conflict therewith and subsequent re-enactment thereof simply cannot form a basis for the presumption that congress intended by the re-enactment to embrace the terms of the invalid regulation.

Moreover, where the statute itself is plain and needs no administrative construction, the doctrine of

statutory re-enactment has no application. See *Biddle* v. *Commissioner*, 86 F. 2d 718 (C.A. 2) affirmed, 302 U.S. 573; *Alcoma Ass'n, Inc.* v. *United States*, 239 F. 2d 365 (C.A. 5); *Oberwinder* v. *Commissioner*, 147 F. 2d 255 (C.A. 8). Obviously, the statute here is plain enough and needs no administrative construction. The amendment to Section 117(j) which was re-enacted "verbatim" in the 1954 Code clearly and unequivocally says that livestock held for breeding purposes is property used in the trade or business of the taxpayer. Accordingly, such livestock are not properly includable in inventory and the regulation which compels their inclusion in the inventory is contradictory to the statute and therefore invalid.

D. *The Taxpayers Have Been Denied a Knowledgeable Choice As To Accounting Methods.*

The Government throughout its Brief contends that both cash and accrual methods of accounting have certain advantages and disadvantages and that when a taxpayer elects his accounting method he not only accepts the advantages, but the disadvantages as well. This reasoning, must, of necessity, assume that the taxpayer had knowledge of the advantages and disadvantages at the time the election is made. However, such reasoning should not be applicable to a situation when the disadvantages were non-existent at the time of election.

Prior to 1951, there was considerable litigation in the courts between taxpayers, such as Elkberg and Bennett, and the Government over the entitlement of capital gains treatment on sale of breeding livestock. Finally, in 1951 it was necessary for Congress to

amend Section 117(j) to make the section specifically applicable to livestock. It has been judicially recognized that the purpose of the amendment in 1951 "was chiefly to clarify the issue and to recognize by statutory enactment the rulings which had been made by the courts". *Gotfredson* v. *Commissioner*, 217 F. 2d 673, 676 (C.A. 6). Thus, it was not until Congress acted in 1951 that it became clear that breeding livestock were subject to capital gain treatment.

When the taxpayers in the instant case had their choice to elect the cash or accrual method of accounting and select a method of valuing inventory in 1938 when they commenced their ranching operations it was not recognized that a rancher could get capital gains treatment on the sale of his breeding animals under any circumstances, regardless of what method of accounting and what method of valuation was adopted. Therefore, these taxpayers did not have a meaningful choice as to accounting and valuation methods because they had to make their selection long prior to 1951 and the consequences of the options available were not known.

And even if it is assumed that it was recognized that capital gains treatment was available on the disposition of breeding livestock if all the other elements were satisfied when the Internal Revenue Service issued I. T. 3666, 1944 Cum. Bull. 270, and that a taxpayer commencing business after that date had a knowledgeable choice as to accounting methods,[15] this would

[15] This was the principal ground upon which **Lewis** was distinguished and certiorari was opposed by the Government in **United States** v. **Ekberg**, 291 F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920 See Brief for the United States In Opposition, pp. 7-8.

have no application to these taxpayers. If these taxpayers had attempted to change from the accrual to the cash method when they continued the operation of their portion of the ranches as a sole proprietorship in 1948 and 1951, they would have been required to secure the Commissioner's consent. [16] There can be no question, and the *Lewis* case clearly shows, that the Commissioner would not even consider such a request, much less approve it, 251 F. 2d at 231.[17] Thus, even under this theory, taxpayers' selection of accounting method was prior to the recognition of capital gains treatment on livestock, and as a consequence, these taxpayers were denied a knowledgeable choice as to accounting and valuation methods.

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[16] See letter ruling of the Deputy Commissioner, 1945 CCH Fed. Tax Service, Vol. 4, para. 6129, where the Internal Revenue Service ruled that if income from a business operated by an individual was reported on the accrual basis and such business is succeeded by a partnership, permission of the Commissioner is required to change to the cash method. The Government's purported distinction of that ruling is untenable and based upon facts not contained in the ruling. There is nothing contained therein to support the Government's assertion that a sole proprietorship accepted a new investor; the new partner could have just as easily been accepted to render services. Similarily, there is nothing to support the assertion that there was no substantial change in the business in that instance. In the instant case, the business carried on by the two sisters was substantially the same as, and not materially different from, the business carried on by the partnership, namely, to conduct the business of breeding and raising cattle for the production and sale of calves on two ranches in West Texas.

Also, in determining whether the taxpayers had a meaningful choice as to accounting and valuation methods in 1948 and 1951, the Court should look to the situation that existed at that time, and not the Treasury Regulations promulgated under the 1954 Code and decisions thereunder which are cited in the Government's Brief, (Br. 25).

[17] In the instant case it was stipulated that during the years 1954-1958, the Commissioner refused to consider rancher's requests to change from the accrual method to the cash method (R. 7-8). A similar situation existed in prior years, Scofield v. Lewis, 251 F. 2d at 131. It is obvious, as evidenced by the Government's position herein, that the Commissioner would have opposed permission to drop such an item from inventory.

II.

TAXPAYERS ARE ENTITLED TO CORRECT THE ERROR CAUSED BY THE INVALID TREASURY REGULATION AND REMOVE FROM INVENTORY RAISED BREEDING ANIMALS INCLUDED IN INVENTORY IN COMPLIANCE WITH THE REGULATION. CORRECTION OF THE ERROR CAUSED BY THE REGULATION DOES NOT CONSTITUTE A CHANGE OF ACCOUNTING METHOD, AND THEREFORE, TAXPAYERS ARE NOT REQUIRED TO OBTAIN THE CONSENT OF THE COMMISSIONER OF INTERNAL REVENUE.

A. *The Commissioner's Consent Is Not Required to Correct An Error Caused By An Invalid Regulation.*

The court of appeals held in the instant case, 344 F. 2d at 229, as it did in the *Lewis* case, 251 F. 2d at 132, that the taxpayers are permitted to remove property used in their trade or business from inventory without the Commissioner's consent. The court of appeals recognized in the *Lewis* case that the Commissioner had the authority to approve or disapprove a change in the accounting method; however, it flatly refused to sanction the effort of the Commissioner to enforce an invalid Regulation by the indirect means of claiming that failure to follow the invalid Regulation

amounted to a change of accounting method requiring the Commissioner's consent. The courts of appeals in effect pointed out in the *Lewis* case that the rule of not changing accounting methods without the Commissioner's consent had no application when the taxpayer was simply undoing what the invalid Regulation had wrongfully required him to do.

The impact of the Government's brief is that even though the Regulation is invalid, the Commissioner's consent is required in any event to correct the error caused by the Regulation. The Government's position is apparently premised on the ground that an accrual basis taxpayer who maintains an inventory can under no circumstances remove or omit an item from inventory once it is included therein, regardless of how it became included in inventory in the first place. A concrete example may serve to underscore the basic incorrectness of the Government's position.

A Woolworth store is admittedly required to keep an inventory on all property held primarily for sale. Let us suppose that a Commissioner issues a Regulation requiring the inclusion of the soda fountain in inventory. Woolworth complies but after the passage of several years, another litigant obtains a decision invalidating the Regulation. What is Woolworth to do? Can they simply drop the item from their inventory when they learn of the decision or must they apply to the Commissioner for permission? Suppose further that the Commissioner refused to grant permission to drop these items from inventory.

It would seem plain and clear that Woolworth could drop the item from inventory and that the law would not require them to do a useless thing, namely, to ask for permission which they knew would not be granted and which in reality was not required because of the invalidity of the Regulation. Permission would not be required for another reason: the dropping of the soda fountain from inventory does not effect any change of accounting method. All it does is omit from the inventory an item which was never held primarily for sale and, therefore, never belonged in inventory in the first place.

The mere fact that Woolworth (after dropping the soda fountain from inventory) continues to inventory *merchandise* does not make their accounting method a hybrid and an illegal method. What they are doing is maintaining in inventory that which is held primarily for sale (merchandise) and omitting that which is held primarily for use in trade or business (the soda fountain).

The same rules apply to breeding herd animals belonging to taxpayers. The omission of these livestock from inventory is no more of a hybrid accounting system, and no more requires the Commissioner's permission than does the Woolworth illustration. To permit the Commissioner to do otherwise would be tantamount to saying to him, in effect, "If you issue an invalid Regulation which contravenes the Statute, you can still require all taxpayers affected by the Regulation to obtain permission from you to disregard it, even though you arbitrarily refused to consider applications to change". This, the court of appeals properly

held in the instant case and in *Lewis* case, the Commissioner could not do. [18]

B. *The Statute, Regulation and Legislative History Do Not Require Commissioner's Consent to Correct An Error Caused by An Invalid Treasury Regulation.*

Taxpayers submit that in any event an analysis of Section 446(e) of the Internal Revenue Code of 1954, Treasury Regulation, §1.446-1(e) and the legislative history of Section 446(e) clearly indicate that removing raised breeding animals from inventory to correct an error caused by the regulation does not constitute a change of accounting method requiring the Commissioner's consent.

The statute itself (Section 446(e) of the Code) is silent as to what constitutes a change of accounting method; it merely provides that taxpayer who changes the method of accounting must secure the consent of the Secretary of his delegate. The Regulation (Treas. Reg. §1.446-1(e) (2) (i)) on the other hand tells us that a change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item.

The taxpayers here certainly are not changing

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[18] The court of appeals stated in the instant case that the taxpayers were justified in correcting the error which the regulation imposed "even though it results in an inordinate deduction against ordinary income in the year in which the correction is made," 344 F. 2d at 229. There is nothing in the record to support the conclusion that the correction would result in an inordinate deduction. This would depend on the taxpayer's tax bracket at the time of inclusion (about which the record is silent) and the time of removal.

their general method of accounting from the accrual (inventory) basis to the cash receipts and disbursements method. After correcting an error and removing breeding animals from inventory, taxpayers will still be on the accrual (inventory) basis and will value animals *held for sale* in the ordinary course of business (the only animals properly includable in inventory) under the unit-livestock-price method at the same unit values. Thus, the method, system and values would be the same.

Similarly, the Taxpayers here, by correction of an error caused by the invalid Regulation would not be changing the treatment of a material item. While the Regulation fails to define what is contemplated by the phrase "changing the treatment of a material item," the legislative history of Section 446(e) is enlightening. The Committee Report, (S. Rep. No. 1622, 83rd Cong., 2d Sess., p. 300) states in part:

> "It (a change in the method of accounting) includes a change in the treatment of a material item such as *a change in the method of valuing inventory*, or a change from an accrual method without estimating expenses to an accrual method with estimated expenses, or vice versa, or a change in the method of depreciating any property." (Emphasis added).

Thus, if the taxpayers in this case were attempting to change their method of valuing inventory, such as from the unit-livestock-price method to the farm-price method, it would be a change of a material item, and would constitute a change of accounting method.

But taxpayers here are making no such attempt; after correcting the error taxpayers will value the animals properly includable in inventory under the unit-livestock-price method just as before. Therefore the Commissioner's permission to correct the error is not required.

Nor, do we have a situation here analagous to the various cases cited in the Government's Brief (Br. 21, fn. 14) [19] where the taxpayers initiated the erroneous accounting treatment and thereafter attempted to change it without the Commissioner's consent. Here, the erroneous treatment is compelled by the Commissioner's invalid Regulation which the Commissioner refuses to correct. Moreover, this is not a case where "the Commissioner is not necessarily opposed to the change" which taxpayer wants to make; here, by refusing to even consider, much less act upon, a request to change, the Commissioner is, in effect, contesting taxpayer's making a proposed change at all. See *American Can Co.* v. *Commissioner*, 317 F.2d 604 (C.A. 2) at page 606 citing *United States* v. *Consolidated Edison Co. of New York, Inc.*, 366 U.S. 380.

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[19] **American Can Co.** v. **Commissioner**, 317 F. 2d 604 (C.A. 2) certiorari denied, 375 U.S. 993; **Wright Contracting Co.** v. **Commissioner** 316 F. 2d 249 (C.A. 5); **Commissioner** v. **O. Liquidating Corporation**, 292 F. 2d 225 (C.A. 3), certiorari denied, 368 U.S. 898; **Broida, Stone & Thomas, Inc.** v. **United States**, 309 F. 2d 486 (C.A. 4), affirming **per curiam** 204 F. Supp. 841 (N.D.W.Va.).

III.

EVEN IF A CHANGE OF ACCOUNTING METHOD IS INVOLVED, THE LAW DOES NOT REQUIRE A TAXPAYER TO DO A USELESS THING BY APPLYING TO THE COMMISSIONER FOR PERMISSION TO CHANGE A PARTICULAR ITEM WHEN THE FACTS SHOW THAT THE COMMISSIONER WOULD HAVE REFUSED TO CONSIDER AND ACT UPON SUCH APPLICATION.

Conceding for the sake of argument only, that a change of accounting method was involved, it would have been useless for the taxpayers here to have filed with the Commissioner an application to change. It has been stipulated that the Commissioner would have refused to consider, and as a consequence to act upon, such an application. (R. 7-8). This is precisely the same situation which existed during the years involved in the *Lewis* case, 251 F.2d at 131.

Conceded, the statute gave to the Commissioner the power to pass on applications for a change of accounting method. Conceded also, the Commissioner is vested with discretion to refuse applications. *The Commissioner, however, is not vested with the power or authority to arbitrarily refuse to even consider applications.*

This Court has previously enunciated the doctrine which requires that public officials vested with discretion power must exercise that discretion and may not arbitrarily determine issues without even considering the merits. As stated by Mr. Justice Clark in *Uni-*

ted States ex rel. Accardi v. *Shaughnessy*, 347 U.S. 260, 267, in a case wherein the Board of Immigration Appeals had predetermined its decision:

> "An if the word 'discretion' means anything in a statutory or administrative grant of power, it means that the recipient must exercise his authority according to his understanding and conscience."

In like manner in *Yellin* v. *United States* 374 U. S. 109, 122, this Court, through Chief Justice Warren, reiterated the position by asserting that even though "Yellin might not prevail" even if given a hearing, nonetheless he was at least entitled to have the Committee (in that instance) "give him consideration."

The taxpayers submit that the Commissioner is not empowered to categorically refuse to even consider applications and then when relief is sought through the Courts, to blandly assert that the filing of these very applications is a condition precedent to the institution of legal action.

After the enactment of the amendment to Section 117(j) and the re-enactment of that Section as Section 1231 of the 1954 Code, it was incumbent upon the Commissioner to make available to accrual basis taxpayers who use the unit-livestock-price method to value inventory, a means whereby such taxpayers could avail themselves of the full benefits of capital gains treatment. It is inequitable and unfair to now permit the Commissioner to successfully assert that the taxpayers are to be denied the full benefits of capi-

tal gains treatment (available to cash basis taxpayers) because they did not pursue a remedy which was never available to them in the first place. Certainly, this "was not what the Congress intended." *Scofield* v. Lewis, 25 F.2d at page 132.

CONCLUSION

In the earliest definitive case (*Albright*) dealing with the application of the capital gains statute to the livestock industry, it was held that the statute was *applicable alike* to all taxpayers within its provisions. No court, no committee of Congress, no house of Congress has never issued any pronouncement, made any report or even hinted at any thought that any taxpayer, otherwise qualified, should be denied the full benefits of what has been labelled a "relief measure".

In essence the Government's argument here is a thinly veiled effort to circumvent the plain intent of the Congress and the Courts. It is an effort to deprive taxpayers such as these, who are valuing animals on the unit-livestock-price inventory method, of a substantial portion of the relief accorded to others. It is well and good to discuss accounting theory, inventory practices and the entire gamut of income taxation, but what is left when the veneer is removed is still a statute and a regulation which plainly contravenes its terms. No amount of philosophical and technical dissertation can obscure that fact. It is that plain and simple.

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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March, 1966

APPENDIX

Internal Revenue Code of 1954:

SEC. 466. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * * *

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate. (26 U.S.C. 446)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or inoluntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges and conversions, such gains and losses shall not be con-

sidered as gains and losses from sales or exchanges of capital assets. * * *

* * * *

(b) *Definition of Property Used in the Trade or Business.*— For purposes of this section.

(1) *General Rule.* The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not —

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year.

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition or similar property, held by a taxpayer described in paragraph (3) of section 1221.

* * * *

(3) *Livestock.*—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held

by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(26 U.S.C. 1231.)

Treasury Regulations on Income Tax (1954 Code):

§1.61-4 *Gross income of farmers.*

(a) *Farmers using the cash method of accounting.* A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources. The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale or purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales

price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder).* * *

(b) *Farmers using an accrual method of accounting.* A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in sub-paragraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in sub-paragraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock

and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for draft, dairy, or breeding purposes, unless included in inventory). All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see sub-paragraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471.

§1.162-12 *Expenses of farmers.*

A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising live-

stock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. * * * Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with §1.61-4. * * *

* * * *

§1.446-1 *General rule for methods of accounting.*

* * * *

(e) *Requirement respecting the adoption or change of accounting method.* * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of account-

ing different from that previously used by him unless such consent is secured.

* * * *

§1.471-6 *Inventories of livestock raisers and other farmers.*

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of §1.446-1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides

for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price-method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of §1.446 -1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several clas-

ses, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price

method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of §1.446-1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market, whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit - livestock - price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar

adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

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No. 535

In the Supreme Court of the United States

OCTOBER TERM, 1965

UNITED STATES OF AMERICA, *Petitioner*

vs.

W. H. WARDLAW, *Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENTS W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. W. WARDLAW, DECEASED, ET AL.

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and are therefore not bound by their selection of the accrual method of accounting or their compelled use of the unit-livestock-price method of valuing their livestock inventories, either to include their raised breeding animals in inventory or to capitalize the cost of raising such animals. 23-31

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the costs of feeding and raising their breeding animals, even though they do not include such animals in their inventory. This new contention not only directly violates the Commissioner's 45 year old Reg. 1.162-12, but is illogical and discriminatory. 31-35

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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 535

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENTS W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. W. WARDLAW, DECEASED, ET AL.

OPINIONS BELOW

The District Court did not file an opinion. Its findings of fact and conclusions of law in **Wardlaw,**[1] et al

1—The Respondents in the case of United States of America vs Wardlaw, Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al, are as follows:

W. H. Wardlaw, Independent Executor
of the Estate of C. W. Wardlaw, Deceased
W. H. Wardlaw
W. R. Whitehead
F. H. Whitehead
L. D. Whitehead
F. J. Barrett
W. R. Hodge
B. E. Wilson

These Respondents commenced this proceeding in Civil Actions Nos. 306-307, 328-333, respectively, against the United States in the United States District Court for the Western District of Texas, Del Rio Division. These cases were consolidated by the United States in No. 21,607, United States of America, Appellant, vs. W. H. Wardlaw, et al, Appellee, in the United States Court of Appeals for the Fifth Circuit. These cases were then consolidated by the Petitioner with No. 21351, United States of America, Appellant, vs. John Catto, Jr. and Roxana Catto, Appellees, in the United States Court of Appeals for the Fifth Circuit, in the Petition for Writ of Certiorari.

(R. 50-64) are reported at 223 F. Supp. 631, and the opinion of the Court of Appeals (R. 104-106) is reported at 344 F.2d 225.

JURISDICTION

The judgment of the Court of Appeals was entered on April 8, 1965 (R. 107-108). The time for filing a petition for a writ of certiorari was extended to and including September 5, 1965 (R. 109 and 111). The petition for a writ of certiorari was filed on September 3, 1965, and granted on November 22, 1965 (R. 112). This Court has jurisdiction under 28 U.S.C. 1255 (1).

QUESTIONS PRESENTED

The Respondents in the **Wardlaw** case, who selected the accrual method of accounting many years before the Commissioner in 1944 acknowledged that breeding animals qualified for capital gains treatment under Section 117 (j), as "property used in the trade or business", and who were compelled by Reg. 111, Sec. 29.22 (c)-6, as amended by T.D. 5423, to use the unit-livestock-price method of valuing their livestock inventory, and were required by the Commissioner's construction of Reg. 1.471-6 (f), and its predecessors, to include their raised breeding animals in inventory, contend that they have a right to remove these raised breeding animals from inventory, and that they have no duty to capitalize the cost of feeding and raising their raised breeding animals but may deduct such raising costs as a current expense, as expressly permitted by Reg. 1.162-12, and its predecessors.

The questions presented in the **Wardlaw** case are:

(1) Can the Commissioner, without statute or regulation to support him, and in the face of express language to the contrary in his own longstanding Reg. 1.161-12, which by the process of statutory re-enactment has, he admits, attained the force of law, refuse to permit an accrual method farmer to expense his raising costs and force him to capitalize them instead?

(2) If the Commissioner cannot do this, can he, nevertheless, require the farmers in the **Wardlaw** case to keep their raised breeding animals in inventory and thereby, indirectly, but effectively nevertheless, force them to capitalize their raising costs, something that Reg. 1.162-12 says he cannot do directly?

STATUTES AND REGULATIONS INVOLVED

In addition to the Statutes and Regulations involved, as stated in Petitioner's Brief (page 3), the following Statutes and Regulations are involved:

Revenue Act of 1942 c. 619, 56 Stat. 798 Section 151 (appearing at page 51, Appendix A)

Revenue Act of 1951 c. 521, 65 Stat. 452 Section 324 (appearing at page 52, Appendix A)

Treasury Regulation 111, Internal Revenue Code of 1939

Section 29.23 (a)-11

Section 29.22 (a)-7

Section 29.22 (c)-6

(appearing at pp. 53-5, Appendix A).

STATEMENT OF FACTS

The taxpayers in the **Wardlaw** case are ranchers engaged in the business of breeding and raising sheep, goats and cattle for the production of wool, mohair, mutton and calves. The taxpayers maintained breeding herds of sheep, goats and cattle for use in connection with their ranching business and, as circumstances required, they selected certain animals at birth from the breeding herd and added same to the breeding herd, the number of animals retained in the breeding herds being determined on the basis of range conditions, rainfall, cost of operation and other factors. Other animals, born on the farm and purchased, were held for sale to customer in the ordinary course of business.

When they commenced business (one of the taxpayers commenced his ranching business prior to 1913, one in 1917, three in 1927, two in 1935, and one in 1941 (R.54)), taxpayers adopted the accrual method of accounting and a constant unit price method of valuing their inventories. After the enactment in 1942 of Section 117 (j) of the Internal Revenue Code of 1939[2], Regulation 111, §29.22(c)-6 was promulgated[3] in 1944, providing that a livestock raiser who, prior to 1944, had adopted a constant unit price method of valuing his livestock inventories, and who had filed returns on this basis, was considered as having "elected" the

---

2—Sub-Section (j) was added to Section 117 by Section 151(b) of the Revenue Act of 1942. c.619, 56 Stat. 798. It provided capital gains treatment for "property used in the trade or business" of a taxpayer. In 1944 the Commissioner conceded that this embraced livestock held for breeding purposes.

3—As amended by Treasury Decision 5423, 1945 Cum. Bull, 70, effective January 1, 1944, the present counterpart of which is Reg. 1.471-6.

"unit-livestock-price method"[4]; §29.22(c)-6 also provided that a taxpayer electing the unit-livestock-price method was required to include in his livestock inventory "all livestock raised, whether for sale or for draft, breeding, or dairy purposes"[5] As a result of being thus compelled by this Section of the Regulations to include their raised breeding animals in inventory, the taxpayers in the **Wardlaw** case were forced to include in their **ordinary income** the initial inventory values of their raised breeding animals and thereafter the annual increases in inventory values assigned to such animals, including the tax years, 1957-1959, inclusive, here involved,[6] (a) despite the fact that Section 117 (j) and its successor, Section 1231 of the Internal Revenue Code of 1954, plainly provided that gain from the sale of "property used in the trade or business" should be taxed as capital gain, (b) despite the fact that the taxpayers had no "meaningful choice"[7] as to ac-

---

4—Reg. 111, Sec. 29.22(c)-6, as amended by T.D. 5423: "A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis, will be considered as having elected the 'unit-livestock-price method'." This method provides for valuation of different classes of animals at a standard unit price for each animal within a class.

5—"Regs. 1.471-6(f) [the present counterpart of Sec. 29.22(c)-6] . . provides that a taxpayer who elects to use the unit-livestock-price method must apply it to all livestock raised including breeding animals. This means that a livestock raiser who uses this method cannot segregate his raised breeding herd and treat it as though it were a capital asset subject to depreciation . . ." United States v. Ekberg, 291 F(2) 913 at p. 917, fn. 5.

6—This result is admitted by the Government (Stip. 25, R. 72); the District Court found as a fact that the result of taxpayers being required by the Regulation to use the unit-livestock-price method and include raised breeding animals in inventory was that the initial inventory value of raised breeding animals put in inventory was taxed as ordinary income and all annual increases thereafter in inventory value of such raised breeding animals were also taxed as ordinary income. (Findings of Fact 11, R. 57).

7—As pointed out in the **Ekberg** case, a "meaningful choice" as to accounting methods and as to methods of valuing inventory was not possible until 1944, when it first became apparent, by reason of the issuance of I.T. 3666, 1944 CB 270, that capital gain was available on the sale of raised breeding animals, provided the rancher did not adopt the accrual method of accounting and the unit-livestock-price method of valuing his inventories.

counting method and no choice at all as to method of valuing their inventories, and (3) despite the fact that the net effect of this forced inclusion was to compel a capitalization of raising costs of breeders, specifically made deductible under Reg. 1.162-12 as a current expense.

The District Court held that the selection of the accrual method of accounting and the unit-livestock-price method of valuing inventory, by the taxpayers in the **Wardlaw** case, when they commenced operating their ranches, was not a meaningful choice inasmuch as the statute then did not authorize capital gains treatment on the sale of livestock used for breeding purposes.[8] (R. 62). The District Court also held that, under these circumstances, the Regulation requiring the inclusion of raised breeding animals in inventory was invalid as to the livestock farmers before the Court; that the requirement that raised breeding animals be included in inventory was in conflict with Section 1231 of the Internal Revenue Code; that Section 1231 of the Internal Revenue Code clearly and unequivocally stated that livestock held for breeding purposes is property used in the trade or business of the taxpayer[9], and as to such livestock taxpayers were not required to include them in inventory or to use the unit-livestock-price method to determine the cost basis of animals sold. (R. 61-62).

8—Actually, the taxpayers in the **Wardlaw** case selected a constant unit price method of valuing their inventory when they commenced business, but as noted above, Reg. 111, Sec. 29.22(c)-6 required that taxpayers using a constant unit price method prior to 1944 were forced to elect and use the unit-livestock-price method for years after 1944. Obviously, the selection of a constant unit price method was not a meaningful choice, because at the time of the selection (long prior to 1944) capital gains treatment for the sale of breeding stock was not authorized.

9—Section 117(j) of the Internal Revenue Code of 1939 was amended by Section 324 of the Revenue Act of 1951, c.521, 65 Stat. 452, to include within the definition of "property used in the trade or business" the present specific reference to "livestock, regardless of age, held by the taxpayer for draft, breeding or dairy purposes"; the 1951 amendment to Section 117(j) was by its terms made applicable to taxable years beginning after 1941.

The Court of Appeals for the Fifth Circuit, noting that the District Court had followed the opinion in **Scofield v. Lewis,** 251 F.2d 128, (C.C.A. 5th, 1958), and recognizing that such opinion was directly in point and was controlling, affirmed the judgment of the District Court with respect to the raised breeding animals.

SUMMARY OF ARGUMENT

Since the early days of the income tax, the Regulations have permitted livestock farmers to take current expense deductions for the cost of raising their livestock. This was the rule whether the livestock were being raised for sale or to serve as breeding animals, and whether the farmer was on the accrual or the cash method of accounting. The regulation has not changed materially over the years.[10] By successive reenactment of the statute under which this regulation was promulgated, the regulation attained the force and effect of law.

In 1942, Congress saw fit to extend capital gains tax treatment to "property used in the trade or business", even though the property was not by definition a capital asset. In 1944 the Commissioner of Internal Revenue published I.T. 3666, which ruled that breeding animals qualified as "property used in the trade or business," and hence capital gains treatment was available on their sale.

The inter-action of the regulation permitting livestock farmers to deduct the cost of raising their breeding animals as a current expense and the statute granting capital gains treatment on the sale of breeding

10—In 1921 the regulation stated that "the cost of feeding and raising livestock may be treated as an expense deduction. . ." Reg. 45, Art. 110. Today it states that "The purchase of feed and other costs connected with raising livestock may be treated as expense deductions. ..." Reg. 1.162-12.

animals created a problem, or at least the Commissioner considered it a problem. To permit the farmer to deduct the cost of raising a breeding animal as a current expense, and then allow him to receive capital gains treatment when the animal was sold was, to the Commissioner, a "distortion"[11] of taxable income and a "windfall"[12] to the farmer. To remedy, or at least alleviate, the situation, the Commissioner promptly sought to curb the application of the new capital gains treatment section by instituting a narrow-as-possible definition of what would constitute breeding animals "used in the trade or business." Congress, however, noting the "considerable confusion and dispute" brought on by the Commissioner's various rulings,[13] rejected these efforts in 1951 by amending Sec. 117(j) expressly to include "livestock, regardless of age, held by the taxpayer for breeding purposes. . ."

Meanwhile, the Commissioner had acknowledged, in I.T. 3666, that there was no way he could keep the cash method farmer from deducting the cost of raising his breeders as a current expense, as permitted by Reg. 1.162-12, or from receiving capital gains treatment upon the sale of his raised breeders, as provided by Sec. 117 (j). At the same time, the Commissioner decided he might have more success against livestock farmers who were on the accrual method of accounting and kept inventories. He realized there was no law or regulation requiring that all accrual method farmers should put their raised breeders in inventory.[14] However, his Regulation 111, Sec. 29.22(c)-6,

11—Letter from the Secretary of Treasury to the Chairman of the Senate Finance Committee, 1952, R. 9, at p. 11.

12—Brief, p. 15.

13—See Senate Report No. 781, 82d. Cong. 1st Sessions, 1951-2. Cum. Bull. 457, 487, fn. 24.

14—The general rule was that livestock raised or purchased **for sale** must be included in inventory, but that livestock acquired (by birth or by purchase) **for breeding purposes** might be included or excluded. Regs. 111, Sec. 29.22(a)-7, corresponding to the present Regs. 1.61-4(b). See also United States v. Ekberg, page 917, fn. 5.

as amended by Treasury Decision 5423 in 1944, seemed to say that any farmer using the unit-livestock-price method of valuing his inventory of animals held for sale must also include his **raised** breeding animals in inventory, and value them by the same method.[15] He therefore took this interpretation as his position, requiring all such farmers to report the initial value given to these raised breeders when they were thus forced into inventory as ordinary income, and to do likewise as to the annual increases in their inventory value thereafter. Since the inventory value given to these raised breeding animals under the unit-livestock-price method equaled (often exceeded) the cost of raising them, the net effect of the Commissioner's position was to force livestock farmers using this method of valuation to capitalize the cost of raising their breeders, as Petitioner admits, rather than deduct such cost as a current expense pursuant to Reg. 1.162-12. The breeding animal was normally kept by the farmer during its useful life, and then sold. In the case of sheep and goats, the selling price would generally not exceed the last inventory value given to the animal, so that the farmer would get no capital gains treatment at all on the sale of the raised breeding animal, since there would be no gain; as for cattle, the cow or bull would normally be sold at a gain, if the market was steady, but the bulk of the increase in value of the breeder, from birth to sale, would have already been taxed as ordinary income, leaving relatively little to be taxed as capital gain.

The **Lewis** case said that Reg. 111, Sec. 29.22-6, as thus construed by the Commissioner to **force** raised breeders into inventory, was invalid. The **Ekberg** case said the regulation was valid only if the taxpayer

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15—The corresponding regulation today is Reg. 1.471-6(f).

elected to use the accrual method of accounting and the unit-livestock-price method of valuing inventories with knowledge of the tax consequences of his election as to his raised breeding animals; and that he could not have had such knowledge if he had had to make his election prior to 1944, it having been recognized in that year, for the first time, by I.T. 3666, that capital gain was available on the sale of breeding animals.

In the **Wardlaw** case now before this Court, the farmer-taxpayers elected the accrual method of accounting many years before I.T. 3666. Consequently, their choice was not "meaningful." Furthermore, the farmers in the **Wardlaw** case **never elected** the unit-livestock-price method; **on the contrary, it was forced upon them** by the Regulations.[16]

Petitioner now says he was wrong in his contention, in the courts below, that Reg. 1.471-6(f), formerly Reg. 111, Sec. 29.22-6, requires that raised breeding animals be put in inventory. Instead, he makes the new contention that this regulation, while not requiring that raised breeders be put in inventory, does require that farmers who have chosen the unit-livestock-price method of valuation must capitalize the raising costs of their breeders anyway, presumably whether they have been included in inventory or not, and cannot expense these costs. Petitioner cites no authority for this new construction of Reg. 1.471-6(f), because, of course, there is none. However, there **is** ample authority to the effect that **the cost of raising breeders is properly deductible as a current expense;** this authority is the Commissioner's own 45-year old Regulation 1.162-12,

16—This was because these taxpayers, long prior to 1944, adopted a constant unit price method of valuing their livestock inventories, and under the amended regulations of December 1944, by Treasury Decision 5423, it was provided that any livestock raiser who, for years prior to 1944, had adopted a constant unit price method of valuing inventories would "be considered as having elected the 'unit-livestock-price' method."

and its predecessors. Moreover, if a particular item is a deductible expense for a livestock farmer on the cash method of accounting, as the Commissioner has acknowledged, it is also a deductible expense for a livestock raiser on the accrual method. The two methods differ as to **when** an item is expensed, but not as to **whether.**

This then is the issue before this Court: Can the Commissioner, without any authority except his latest construction of Reg. 1.471-6(f), and in the face of express language to the contrary in his own longstanding Reg. 1.161-12, which by the process of statutory re-enactment has, he admits,[17] attained the force of law, refuse to permit an accrual method farmer to expense his raising costs and force him to capitalize them instead? If the Commissioner cannot do this, can he, nevertheless, require the farmers in the **Wardlaw** case to keep their raised breeding animals in inventory and thereby, indirectly, but effectively nevertheless, force them to capitalize their raising costs, when Reg. 1.162-12 says that such costs are deductible as a current expense?

ARGUMENT

I

Since the early days of the income tax, all livestock farmers have been permitted, under what is now Reg. 1.162-12, to deduct the cost of raising their breeding animals as a current expense. This right cannot be denied by forcing raised breeding animals into inventory, or by requiring such costs to be capitalized.

A livestock farmer, like any other taxpayer, must choose his method of accounting when he first begins business. This is the only time he has a choice, and his

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17—Brief, p. 16.

choice is between the cash receipts and disbursements method and the accrual method. Once he makes a selection, he must stay with it for all subsequent years. The difference between these two methods of accounting is simply one of timing. The taxpayer on the cash method reports his income when he receives it, and deducts his expenses when he pays them; whereas the accrual method taxpayer deducts his expenses when they are incurred, even though not yet paid, and reports his income when it has accrued, even though it has not yet been received. A livestock farmer using the accrual method keeps an inventory of his livestock held for sale.[18] He computes his gross income by reference to his inventory at the opening of the taxable year and at the close of the taxable year. He does this by increasing the value of his inventory at the close of each year to reflect the increase in the value

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18—"A taxpayer's taxable income shall be computed upon the accounting method by which his books are kept. Sec. 446(a). Recognized and permitted general methods of accounting include the cash receipts and disbursements method, an accrual method, and combinations of these. Sec. 446(c). The cash receipts and disbursements method generally contemplates the inclusion of income for the year in which received and the allowance of deductions for the year in which paid. The accrual method generally relates income and deductions to the year in which earned or incurred. Regs. Sec. 1.446-1(c) (i) and (ii). A taxpayer filing his first return may adopt any permissible method of accounting. Regs. Sec. 1.446-1(e) (1). Once having chosen his method, however, the taxpayer, if he wishes to change it and before computing his taxable income under a new method must secure the consent of the Commissioner. Sec. 446(e) and Regs. Sec. 1.446-1(e) (2).

"A farmer—and this includes a rancher such as the taxpayer here, Regs. Sec. 1.61-4(d)—has, as does any other taxpayer, the same initial choice of accounting method. He may use the cash receipts and disbursements method or he may use an accrual method. Having elected one method, he must stay with it for subsequent years unless authorized by the Commissioner to change his method. Regs. Sec. 1.471-6(a). If, however, he uses the accrual method then he must use inventories to determine his gross income. Livestock raised or purchased for sale **shall be** included in the inventory at their proper valuation, and livestock acquired for draft, breeding, or dairy purposes and not for sale **may be** included in the inventory . . . instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. Regs. Sec. 1.61-4(b)." (Emphasis added.) See United States v. Ekberg, pp. 916-17, fn. 5.

of his livestock on account of their getting older and larger and therefore presumably having a higher market value. Long before the Regulations, in 1944, expressly and for the first time authorized the "farm-price method" and the "unit-livestock-price method" of valuing livestock inventories,[19] many livestock farmers, instead of putting their livestock in inventory at cost, or at cost or market whichever was lower, followed the practice of giving all their livestock a fixed unit value based on age, type of animal, and sex. Thus a one-year old cow, a yearling heifer, would be given a certain value, a two-year old cow a greater value, etc. The same would be done for sheep, for goats, and other farm animals. This was known as a "constant unit" method of valuation, and, as indicated, it was practiced by livestock farmers long before the advent, in 1944, of the Regulation authorizing the farm-price method and the unit-livestock-price method. By using this "constant unit" method, the livestock farmer created taxable income before he actually realized it, for as soon as the animal was put into inventory at a unit value, ordinary income resulted; and as the inventory value increased with the aging of the animal, additional income was created. In the early days of taxation, this was helpful, because the farmer could, in this manner, create income to offset against the deductible expenses incurred in feeding and caring for his livestock. Today, however, there is no particular advantage in doing this because of the statutory right to carry operating losses forward and offset them against income of a later year.[20]

Long before the advent of the regulation which

19—The unit-livestock-price method provides for valuation of different classes of animals at a standard unit price for each animal within a class. The farm-price method was an alternative method whereby animals in inventory were valued according to their current market value less cost of marketing.

20—This statutory right first appeared in the Revenue Code adopted by Congress in 1939.

has helped to give rise to the present controversy, namely, Reg. 1.471-6 (f), and its predecessor, livestock farmers followed the practice of including their raised breeding animals in inventory along with their animals held for sale to customers in the ordinary course of business. This was done as a matter of convenience, and because there was no difference in the tax treatment of the profit on the sale of breeding animals as distinguished from the profit on animals held for sale to customers. In both instances the profit was taxable as ordinary income. There was no law or regulation requiring that raised breeding animals either be included in inventory or excluded, and there was no suggestion that Congress would, in 1942, expressly extend capital gains treatment to livestock held for breeding purposes. The cash method farmer and the accrual method farmer were treated just alike, tax-wise, both on the sale of animals held for breeding purposes and animals held for sale to customers, the only difference being the timing of the tax: for the cash method farmer there would be no tax until he sold the animal, but for the accrual method farmer profit on the animal would be anticipated by using inventories, and the tax would therefore be paid before profit was in fact realized. However, in both instances the profit would be taxed as ordinary income, and until 1942 there was no suggestion that profit from the sale of breeding animals would be taxed as capital gain.

In 1942 Congress extended the privilege of capital gains treatment to the sale of certain assets theretofore expressly excluded from the statutory definition of "capital assets". Section 117 (a) of the Internal Revenue Code of 1939 gave the same broad general definition to "capital assets" as does the present Section 1221, and then excluded from that definition, as does Section 1221, stock in trade, inventory prop-

erty, property held primarily for sale to customers in the ordinary course of business, and property used in the trade or business subject to the depreciation allowance. There was nothing in the 1939 Code, as originally enacted, which corresponded to the present Section 1231 of the 1954 Code granting capital gains treatment to property used in the trade or business. The predecessor to Section 1231 was Section 117 (j) of the amended 1939 Code; it appeared originally in the Revenue Act of 1942. This new section defined "property used in the trade or business" to be property so used which was subject to the depreciation allowance[21] and held for more than six months, and which was not inventory property or property held primarily for sale. This new section extended the benefits of capital gains treatment to property falling within this definition of "property used in the trade or business".

In 1944, the Commissioner of Internal Revenue, in I.T. 3666, recognized generally that breeding animals were "property used in the trade or business" within the definition of Section 117 (j), and that capital gains treatment was therefore available on the sale of such animals.[22] However, he promptly thereafter initiated a series of efforts to restrict the application of the section in this area as much as possible by narrowing

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21—A raised breeding animal is subject to the allowance for depreciation, but because the animal was born on the farm it has no acquisition cost and therefore nothing to depreciate. Petitioner attempts to rationalize I.T. 3712, 1945 Cum. Bull. p. 176, later revoked, which prohibited a livestock farmer on the accrual method of accounting and using the unit livestock price method from depreciating his raised breeding animals. Brief, p. 32, fn. 23.

22—"Any livestock used for draft, breeding, or dairy purposes, irrespective of whether such live stock was raised or otherwise acquired, is property used in the trade or business, of a character which is subject to the allowance for depreciation, within the meaning of section 117(j) of the Internal Revenue Code, provided it is held for more than six months. This is equally true whether the farmer keeps his books and files his returns upon the cash receipts and disbursements basis or upon the accrual basis."

the definition of what constituted a "breeding animal" for purposes of Section 117 (j).[23] Finally, Congress in 1951 recognized the "confusion and dispute" into which the Commissioner had brought this area of the law[24], and sought to end the confusion by amending Section 117 (j) of the 1939 Code to include specifically within the definition of "property used in the trade or business", "livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes . . ." This amendment, which now appears as Section 1231 (b) (3) of the 1954 Code, was, by its terms, made applicable to taxable years beginning after 1941. The 1951 amendment to Section 117 (j) "came into being, not because of contrary case law which Congress disapproved, but because of the Commissioner's continuing reluctance to give full application of the statute to breeding stock."[25]

23—The first attempt was in 1944, where the Commissioner, in I.T. 3666, 1944 CB 270, held that animals culled from the breeding herd as feeder or slaughter animals were not entitled to capital gains treatment. The second attempt was in 1945, in I.T. 3712, 1945 CB 176, where the Commissioner set forth an abnormal-normal sales test for determining whether sales of livestock from the breeding herd were or were not entitled to capital gains treatment. The third attempt was in 1951, where the Commissioner, in Mimeograph 6660, 1951-2 CB 60 held that capital gains treatment would be given to breeding animals sold from the herd only if they had been actually used for breeding purposes for substantially their full period of usefulness. These efforts on the part of the Commissioner to restrict the capital gains treatment granted by Congress no doubt forced many taxpayers to pay taxes that they should not have paid, but as time passed the Commissioner was forced to retreat on I. T. 3666 and I. T. 3712 by the Eighth Circuit Court of Appeals in Albright v. United States, 173 F. 2d 339, and by the Fifth Circuit Court of Appeals in United States v. Bennett, 186 F. 2d 407. He was forced to retreat on Mimeograph 6660 by the 1951 Senate amendment to Section 117(j). At the time of this amendment, the Senate took note of the "new uncertainties" resulting from Mimeograph 6660. Thereupon, by Mimeograph 6676, 1952-1 CB 71, the Commissioner revoked Mimeograph 6660.

24—Senate Report No. 781, 82d. Cong. 1st Session, 1951-2, C.B. 457, 487, contained comments upon the changes proposed in Sec. 117(j) by the then pending Revenue Act of 1951. It recited the existence of "considerable confusion and dispute for several years" as to the use or sale aspects of livestock held for breeding purposes. It referred to I.T. 3666, I. T. 3712, two litigated cases, Mim. 6660, and to "new uncertainties" resulting from this last regulation. See United States v. Ekberg, supra, p. 920.

25—United States vs. Ekberg, supra, p. 923.

While the enactment by Congress of the 1951 amendment to Section 117 (j) ended the Commissioner's efforts to restrict the application of Section 117 (j) by narrowing the definition of what constituted breeding animals, the Commissioner continued his previously begun attempts to force livestock farmers to capitalize, rather than expense, the cost of feeding and raising their breeding animals.[26] Presumably his theory was that the cost of feeding, sheltering, medicating and otherwise caring for and maintaining the breeding animal during its growth period was actually equivalent to purchasing the animal, and should therefore be capitalized as the purchase price and not deducted annually as a current expense. However, this theory ran into the formidable obstacle that expenses of this nature were clearly ordinary expenses of operation and could not logically be treated as the purchase price of an animal, and the even more formidable obstacle that one of the oldest and most firmly established regulations of the Commissioner stated categorically that **the cost of feeding and raising livestock is deductible as a current expense.** This regulation, which is now Reg. 1.162-12, originated as Reg. 45, Art. 110, in the year 1921, and read as follows:

> ". . . the cost of feeding and raising livestock may be treated as an expense deduction. . ."

This same provision appears in all succeeding regulations of the Commissioner, without material change, and the Regulations today, Reg. 1.162-12, provide exactly the same thing, with only a slight change in wording:

> "The purchase of feed and other costs connected with raising livestock may be treated as expense deductions. . ."

26—This effort began early. In I.T. 3666, it was conceded that a cash method farmer could deduct these raising costs, but the position of the accrual method farmer on this point was left vague.

This regulation has become imbedded in the law as a result of having been part of the Regulations for 45 years, during which time the statute under which the regulation was promulgated has been re-enacted several times. As stated in a letter of June 2, 1952 from the Secretary of the Treasury to Senator Walter F. George, Chairman of the Senate Finance Committee:

> ". . . since the early days of the income tax, the regulations have permitted farmers to take current expense deductions for the cost of raising livestock intended for draft, breeding, or dairy purposes."[27]

The above quoted regulation is clear and explicit, in no way ambiguous. It does not say that it applies only to farmers using the cash receipts and disbursements method of accounting, and it does not say that it applies only to livestock held for sale to customers in the ordinary course of business. Clearly it is available to any one who raises livestock, regardless of his method of accounting, and clearly it applies to all livestock raised, regardless of whether the livestock are raised for breeding purposes or for sale to customers.

In view of the foregoing regulation, the Commissioner made no attempt to force a livestock farmer using the cash method of accounting to capitalize the cost of feeding and raising his breeding animals; the 45-year old regulation was an obstacle he simply could not overcome.[28]

27—R. 9.

28—As early as 1944 the Commissioner recognized that the cash method livestock farmer was entitled to expense the cost of raising his breeding animals, and that such costs would not be capitalized. See I.T. 3666, where it is stated, inter alia, that ". . in the case of the farmer operating upon the cash receipts and disbursements basis the full cost of raising or acquiring such live stock may . . [be] deducted as an expense and . . in such case, upon the sale of any such live stock, the basis for the calculation of gain or loss is zero."

However, in dealing with the livestock farmer who used the accrual method of accounting and maintained inventories, the Commissioner found language in a section of his Regulations that led him to believe that he could force a limited group of livestock farmers to capitalize the cost of feeding and raising their breeding animals, despite Reg. 1.162-12 and its predecessors. This was the group of farmers who used the accrual method of accounting and the unit-livestock-price method of valuing their inventories. The regulation thus seized upon by the Commissioner was Regulations 111, Sec. 29.22(c)-6, the predecessor of what is now Reg. 1.471-6 (f). This predecessor regulation, which was promulgated in December 1944 by Treasury Decision 5423, 1945 Cum. Bull. 70, "permitted farmers raising livestock to value inventories according to either the farm-price method or the unit-livestock-price method. . . That portion of Regs. Sec. 29.22(c)-6, as so amended in 1944, which corresponds to the present Regs. Sec. 1.471-6 (f), read as follows:

> 'A taxpayer who elects to use the unit-livestock-price method must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes . . .' " United States v. Ekberg, supra, p. 918, fn. 5.

The Commissioner construed the above quoted regulation as **compelling** a livestock farmer on the accrual method of accounting and using the unit livestock price method of valuing his livestock inventories to include his raised breeding animals in inventory along with his animals held for sale to customers in the ordinary course of business. This was the position taken by the Commissioner in the **Lewis** case, in the

Ekberg case, and in the cases now before this Court.[29] Petitioner has stipulated that the raised breeding animals of the Respondents in the **Wardlaw** case were **required** by the regulations to be included in inventory.[30] The **Ekberg** case stated that

> "... Regs. 1.471-6 (f) ... provides that a taxpayer who elects to use the unit-livestock-price method must apply it to all livestock raised including breeding animals. This means that a livestock raiser who uses this method cannot segregate his raised breeding herd and treat it as though it were a capital asset subject to depreciation ..."[31]

Reg. 1.471-6 (f), and its predecessor, as thus construed by the Commissioner, required the accrual method farmer using the unit-livestock-price method of valuing his inventory to include his raised breeders in inventory along with his livestock held for sale to customers in the ordinary course of business. Thus, raised breeding animals would be put into inventory at the close of the year of birth at a standard unit price roughly equal to the farmer's actual cost of raising the animal to that age. At the end of the next year, this same animal would appear in closing inventory at a higher figure, roughly equal to the actual cost of raising the animal during its second year. The end of the third year would see a further increase in the inventory figure. This process of putting raised breeding animals in inventory at the close of the year of birth, and increasing the inventory value of the animal at the close of each year thereafter, until maturity, of course created ordinary income for the farmer each

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29—As we shall see, Petitioner now admits that this position was erroneous and that actually Reg. 1.471-6(f) does **not** require that a livestock farmer using the unit-livestock-price method of valuing his inventory must include his raised breeding animals in inventory.

30—R. 67, Par. 5.

31—United States v Ekberg, supra, p. 917, fn. 5.

year, thereby taxing the full inventory value of the animal, and consequently its entire raising cost, as ordinary income. When the animal reached maturity, its inventory value would be at a peak. Generally, the breeding animal would be kept during his useful life as a breeder and thereafter sold. The sale price of sheep and goats would rarely exceed the value at which the animal last appeared in inventory.[32] Thus the Commissioner, by taxing the initial inventory value of the raised breeding animal as ordinary income, and taxing each subsequent year's increment in inventory value as ordinary income, succeeded in taxing the bulk of the increase in the raised breeder's value as ordinary income, rather than as capital gain. Raising costs were thus completely capitalized, rather than permitted as a current expense deduction.[33] The Commissioner then allowed the livestock farmer to use the last inventory value as basis on the sale of the raised breeding animal; however, this merely prevented the taxpayer from being taxed twice on the same increase in value, once as ordinary income and then as capital gain, since the full inventory value of the animal had already been included in his taxable income and taxed at ordinary income rates!

As indicated above, from the very beginning the Commissioner recognized that, in view of Reg. 1.162-12, there was no way he could deny to the cash method farmer the right to deduct as current expenses the cost of feeding and raising his breeding animals and force him to capitalize these expenses. He recognized that Reg. 1.162-12 had acquired the force

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32—As for cattle, sale price generally exceeded inventory, but the margin varied greatly and depended largely on the unit price used and the strength of the market.

33—Petitioner has admitted that the net effect of putting raised breeders in inventory was to capitalize raising costs. Stip. 8 and 9, 25, R. 67-68, 72-73.

and effect of law, and he realized that only by a change in the statute law itself could the regulation be overturned. Accordingly, in 1952 the Commissioner attempted to get the Senate to pass legislation which would deny raising costs of breeding animals as a current expense deduction, and require that same be capitalized. When the Senate refused to adopt any such legislation, the Commissioner gave up as to the cash method farmer. This left the accrual method farmer using the unit-livestock-price method of valuing his inventory as the sole remaining victim on whom the Commissioner continued to vent his displeasure with the statute extending capital gains treatment to livestock held for breeding purposes.

As we have seen, the net effect of forcing the accrual method livestock farmer using the unit-livestock-price method of valuation to put his raised breeders in inventory was to force him to capitalize his raising costs. Petitioner admits that this is true.[34] This attempted circumvention of Reg. 1.162-12 is not supportable, for the following reasons:

(1) The Commissioner's own 45-year old Regulation 1.162-12, which Petitioner admits has attained the force and effect of law, flatly provides that any livestock farmer is entitled to deduct his raising costs as a current expense; obviously if you force him to put his raised breeding animals in inventory you are neutralizing the deduction now by creating artificial ordinary income, and you are not allowing the deduction later as an offset against ordinary income but only as an offset against capital gain. This is a clever, but, it is submitted, an invalid attempt to deny the accrual method farmer using the unit-livestock-price method of valuation his fundamental right to deduct his raising costs **as a current expense.**

34—See footnote 33, supra.

(2) There can be no logic or reason behind telling a cash method farmer that the cost of feeding and raising his breeding animals constitutes a deductible current expense, and at the same time telling an accrual method farmer using the unit-livestock-price method of valuation that the cost of feeding and raising **his** breeding animals is **not** a deductible current expense but must be capitalized! On the very face of it, and apart from it being grossly prejudicial to the accrual method farmer, this simply does not make sense. If the cost of feeding and raising breeding animals is a current expense for the cash method farmer, it must be a current expense for the accrual method farmer. The two methods differ as to **when** an item is expensed, but not as to **whether!**

(3) Finally, there is the fundamental fact that paying out money annually to feed, shelter, medicate, and otherwise care for and sustain a farm animal is clearly an expense of current operations, normal and necessary, whether the animal is being held for breeding purposes or for sale, whether the animal is growing or not growing, and by no reasonable stretch of the imagination can these costs be equated to purchasing an animal from an outsider.

II.

The taxpayers in the Wardlaw case

(1) Did not have a "meaningful choice", under the doctrine of the Ekberg case, when they selected the accrual method of accounting many years prior to 1944, and

(2) Did not have any choice at all as to the method of valuing livestock inventory they would use, being forced by the Regulations to use the unit-livestock-price method,

and are therefore not bound by their

selection of the accrual method of accounting, or their compelled use of the unit-livestock-price method of valuing their livestock inventories, either to include their raised breeding animals in inventory or to capitalize the cost of raising such animals.

The Commissioner's practice of construing Reg. 1.471-6 (f) to mean that accrual method farmers using the unit-livestock-price method of valuation **must** include their raised breeding animals in inventory along with their animals held for sale to customers in the ordinary course of business, first came to the attention of the courts in the **Lewis** case, decided in 1958. There the Circuit Court of Appeals stated that it found nothing in the 1951 amendment to Section 117 (j) indicating a congressional design to limit the extent of capital gains treatment to be accorded livestock farmers selling animals from a breeding herd simply because of their previously having selected the unit-livestock-price method of valuing their inventories.[35] In the **Lewis** case, the taxpayer began business in 1939, and at that time had his one and only opportunity to choose between the accrual method of accounting and the cash method. Furthermore, because the taxpayer in the **Lewis** case had, prior to 1944, apparently pursued a constant unit price method of valuing his inventories, and had filed returns on that basis, he was **compelled,** by virtue of Regs. 111, Sec. 29.22 (c)-6, as amended by Treasury Decision 5423, to use the unit-livestock-price method after 1944.[36] Therefore, under the "meaningful choice" doc-

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35—Scofield v. Lewis, supra, at p. 132.

36—In December of 1944, by Treasury Decision 5423, Cumulative Bulletin 1945, page 70, Reg. 111, Sec. 29.22 (c)-6 was amended to permit farmers raising livestock to value their livestock inventories according to either the farm-price method or the unit-livestock-price method, the closing paragraph of this amendment stating that

(Continued on next Page)

trine of the **Ekberg** case, as hereinafter discussed, the taxpayer in the **Lewis** case did not have a "meaningful choice" when he selected his method of accounting, because it was not until I.T. 3666 was published in 1944 that it was clearly recognized that capital gains treatment was available for the disposition of breeding cattle. I.T. 3666 recognized that breeding animals would qualify as "property used in the trade or business" under Section 117 (j), but it also noted a great difference in the extent of capital gains treatment that would be accorded cash method farmers and accrual method farmers who put their raised breeders in inventory. Hence it was vitally important that a farmer should not elect the accrual method of accounting and put his raised breeders in inventory, or adopt a method of valuing his inventory that would **require** him to do so, such as the unit-livestock-price method!

In the **Ekberg** case, decided in 1961, the taxpayer began his livestock business **after** 1944, and at that time selected the accrual method of accounting and the unit-livestock-price method of valuing his livestock inventory. Later, the taxpayer sought to remove his raised breeding cattle from inventory. The Commissioner objected, stating that "this taxpayer has freely selected and uses the accrual-inventory method of accounting and the unit-livestock-price method of evaluation,"[37] and that he was therefore bound by his

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"A livestock farmer who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis **will be considered as having elected the 'unit-livestock-price method'.**" (Emphasis added.)

Thus any livestock farmer who was in business prior to 1944, and who used the accrual method of accounting and a constant unit-price method of valuing livestock inventory, such as the farmers in the **Wardlaw** case, was **compelled** by the above-quoted language of Reg. 111, Sec. 29.22(c)-6, as amended by Treasury Decision 5423, **to use the unit-livestock-price method of valuation whether he wanted to or not!**

37—United States v. Ekberg, supra, p. 916.

election. The Circuit Court of Appeals, however, recognizing the tremendous difference in the treatment accorded by the Commissioner to livestock farmers using the cash method of accounting and livestock farmers using the accrual method of accounting and the unit-livestock-price method of inventory valuation,[38] probed into the question of whether the "election" of the taxpayer was (1) a blind choice between the cash method and the accrual method, without the taxpayer having any reason to know that one method would give full capital gains treatment while the other would not, or was (2) a "meaningful choice", with knowledge of the extremely disparate tax consequences flowing from each method of accounting. The Court also inquired as to whether the taxpayer's selection of the unit-livestock-price method had been, by the same test, a "meaningful choice". The Court then found that I.T. 3666, issued in 1944, clearly recognized that capital gains treatment was available for the disposition of breeding cattle.[39]

38—"The taxpayer has kept his books and records on the accrual basis of accounting; because of this, he has been required by the applicable regulations . . to use inventories to determine gross income. He has also employed the unit-livestock-price method of valuing his livestock inventory; because of this, he has been required by the applicable regulations, Sec. 1.471-6(f), to apply that method to his breeding livestock as well as to his cattle held for sale. Specifically, he has assigned in the taxable year of birth, a full unit price of $70 to each new heifer. . .

"This addition to inventory at the unit price of each new heifer in the breeding herd results in an increase in the taxpayer's ordinary income for the taxable year and in a reduction in the gain, if any, upon the animal's subsequent disposition. If, in contrast, the taxpayer could carry each breeding animal at a zero basis, as would be the case if he used the cash receipts and disbursements method, its birth would not create ordinary income, its net disposition price would constitute gain in its entirety rather than in part, and, with all other qualifying factors satisfied, that gain would be afforded capital gains treatment rather than ordinary income treatment. The taxpayer presumably, as is the case for each of the three taxable years here, would then enjoy a lower income tax." United States v. Ekberg, supra, p. 915.

39—Ekberg v. United States, supra, p. 917, fn. 5. With the disparate results, as between cash method farmers and accrual method farmers who put their raised breeders in inventory, as noted supra, fn. 38.

The Court then concluded as follows:

> "As we have noted, I.T. 3666, which was issued in 1944, **and thus well before the taxpayer's selection of the accrual-inventory method and of the unit-livestock-price evaluation system,** clearly recognized that capital gains treatment was available for the disposition of breeding cattle if all other necessary elements were satisfied. We conclude that the taxpayer at the inception of his business was not denied the opportunity of making a considered and meaningful choice of available options."

In other words, the Court reasoned that, after 1944, when I.T. 3666 was issued, a livestock farmer should have known that if he used the cash method of accounting he could deduct his raising costs as current expenses and pay capital gains taxes on the amount received for his raised breeding animal, whereas if he elected the accrual method of accounting and the unit-livestock-price method of valuing his inventory he would be required to include his raised breeding animals in inventory, thereby losing the right to deduct the cost of raising his breeders as a current expense and instead being compelled to capitalize these costs; the Court then concluded that if the farmer, **after 1944,** selected the accrual method of accounting and the unit-livestock-price evaluation system, he should be bound by his election. But if he made his selection prior to 1944, and that was the only selection he had, then he should not be bound by his choice, because, coming before 1944, it would not be "meaningful." This has become known as the doctrine of "meaningful choice".

In the **Wardlaw** case, the livestock farmers were in essentially the same position as the taxpayer in the **Lewis** case; but were not in the same position as the

taxpayer in the **Ekberg** case, where the taxpayer selected his accounting method and his method of valuing his inventories subsequent to 1944, which made his choice a "meaningful choice". In the **Wardlaw** case, the farmers **began business long before 1944,** and it was when they began business that they had their one and only opportunity to chose an accounting method. Since this opportunity occurred prior to 1944, it was not a "meaningful choice", and hence not binding on them as a matter of election. Furthermore, the farmers in the **Wardlaw** case selected their method of valuing inventories when they began business, which as noted was long before 1944. Hence, that election was not a "meaningful choice" either. They had no subsequent opportunity either to select a different accounting method or to change their method of valuing their inventories. Ordinarily, they could have switched to the farm-price-method of valuing their inventories in 1944, when the Regulations first offered this method and the unit-livestock-price method to all livestock farmers; but the regulation that offered the farm-price method and the unit-livestock-price method to all farmers in 1944 contained the following requirement:

> "A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis **will be considered as having elected the 'unit-live-stock-price method'.**" (Emphasis added.)

Because of this sentence in the Regulations, the farmers in the Wardlaw case had no choice of valuation method whatsoever in 1944, but were compelled to "elect" the unit-livestock-price method. Under the Commissioner's then interpretation of the Regulations, farmers who elected to use the unit-livestock-price

method were required to include their raised breeding animals in inventory. As we have seen, this inclusion of breeders in inventory created ordinary income in the year of inclusion and in each year thereafter until the breeder reached maturity, and this ordinary income completely offset the deduction for raising costs granted by Reg. 1.162-12, and its predecessors, and the net result of this, as Petitioner admits, was to require that raising costs be capitalized rather than deducted. This was a satisfactory result for the Commissioner, but harsh treatment for livestock farmers in the **Wardlaw** case category. **To say that they elected the unit-livestock-price method of valuation is obviously false. They did not elect it, but were forced to adopt it.**

Petitioner's position on the "meaningful choice" doctrine of the **Ekberg** case has been one of considerable vacillation. In its argument in the courts below in the **Catto** case, now before this Court, it pressed the contention that the taxpayers in that case did have a meaningful choice, and therefore were bound by their election. In its argument in the **Wardlaw** case in the courts below, **Petitioner has acknowledged that the Wardlaw farmers did not have a meaningful choice,** stipulating that the taxpayers began their livestock business, and made their one and only selection of accounting method, long before 1944, and in 1944 were **compelled** to use the unit-livestock-price method of valuing their inventories because they had, in years prior to 1944, used a constant unit method of valuing their inventories. R. p.67, par. 5. Despite this recognition that the farmers in the **Wardlaw** case did not have a meaningful choice, the Petitioner nevertheless insists that the farmers in the Wardlaw case have no right to correct the situation by taking their raised breeding animals out of inventory.

Again, in opposing the petition for a writ of certiori in the **Ekberg** case, the Government stressed the importance of "meaningful choice", pointing out that the taxpayer in the **Lewis** case did not have a meaningful choice whereas the taxpayer in the **Ekberg** case did. Even in Petitioner's Brief in Support of his Petition for certiori in the instant cases, Petitioner recognized this vital distinction of "meaningful choice".[40]

Despite Petitioner's past concern for the "meaningful choice" doctrine, Petitioner now "disagrees" with that doctrine.[41]

It did not make sense to the court in the **Lewis** case, it did not make sense to the court in the **Ekberg** case, and it does not make sense now, to hold that a livestock farmer should be denied the full capital gains treatment offered explicitly to him by Congress simply because in years prior to such offer, or long before the farmers accounting method or his inventory valuation method had any significance at all from the standpoint of capital gains treatment for breeding animals, the farmer had selected the accrual method of accounting and a constant unit price method of valuing his livestock inventories.[42]

40—See Brief for the Respondent in Opposition, in the **Ekberg** case, at p. 7, relevant portions being quoted at p. 8 of the Brief for the Respondent in Opposition, in the **Wardlaw** case.

41—However, the Petitioner wants to eat his cake and have it too: While rejecting the doctrine of "meaningful choice" on page 19 of his Brief, on pages 24-25, fn. 15, he points out that the taxpayers in the **Catto** case had a meaningful choice: "It is evident from the record that the respondents in **Catto** did have an opportunity to change from the accrual to the cash method of accounting after it had become clear that breeding cattle were subject to capital gain treatment." Thus, when the doctrine seems to serve his purposes, the Petitioner espouses it, but when it confronts him with an obstacle, as in the **Wardlaw** case, he disagrees with it. B. pp. 18-19.

42—The Ekberg case recognized this principal of equity when it required, in order to bind a farmer to a prior election, that the prior election be a meaningful or knowledgeable choice, and not just a blind chance. This principal was recognized with approval

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Petitioner has never denied the fact that the taxpayers in the **Wardlaw** case **did not** have a meaningful choice, either as to accounting method or as to method of valuing their livestock inventories. However, Petitioner has apparently sought to obscure this fatal weakness in his case against the farmer-taxpayers in the **Wardlaw** case by consolidating the **Wardlaw** case with the **Catto** case, in which case the Petitioner has argued repeatedly that the taxpayers **did** have a meaningful choice. It is respectfully submitted that this Court should not, and will not, permit the alleged facts of one case to obscure the facts of another case, even though the two cases have been joined for purposes of bringing the overall problem to the attention of this Court.

III

Petitioner no longer contends, as he did in the District Court and the Court of Appeals, below, that, under Reg. 1.471-6 (f) and its predecessor, an accrual method farmer using the unit-livestock-price method of valuing his inventories must include his raised breeding animals in inventory. He now says that the Regulations do not require this. His new contention is that livestock farmers who have chosen the unit-livestock-price method of valuing their inventory must capitalize the costs of feeding and raising their breed-

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in Little v. Commissioner, 294 F.(2) at p. 665 where the Court said that "the recent decision in United States v. Ekberg provides support for our conclusion." Banks v. Commissioner, 322 F(2) 530, although actually not involving the problem now before this Court, and Gibbs v. Commissioner, 33 TC 37, involving a taxpayer who began business in 1949 and was therefore, under the doctrine of the Ekberg case, bound by his election, recognized and followed the equitable doctrine of the Ekberg case. Neither Visintainer v. United States, 301 F. (2) 312, affirming per curiam 191 F. Supp. 425, nor Tee Bar Ranch Co. v. United States, 63-2 U.S.T.C. par. 9663, involved raised breeding animals. Of all these cases, only the Lewis and Ekberg cases have considered in depth the problem now before this Court.

ing animals, even though they do not include such animals in their inventory. This new contention not only directly violates the Commissioner's 45-year old Reg. 1.162-12, but is illogical and discriminatory.

With the filing of his brief in this Court, Petitioner has materially altered his position on what was regarded as the critical point in the cases now before this Court as they were argued in the District Court and the Court of Appeals, below. In the **Wardlaw** case, the revenue agents in the field required the taxpayer-farmers to put their raised breeding animals in inventory. Petitioner's position throughout this litigation, until now, has been that Reg. 1.471-6 (f) required that this be done.[43] Moreover, Petitioner has stipulated that the taxpayers in the **Wardlaw** case were required by the Regulations to carry all their livestock, including their raised breeding herd, on an inventory basis.[44] Furthermore, both **Ekberg** and **Lewis** were decided on the premise that Reg. 1.471-6(f) required an accrual method farmer using the unit-livestock price method to include his raised breeding animals in inventory.[45]

43—"The Commissioner has required, however, that farmers using the unit-livestock-price method apply that same valuation approach to their raised breeding animals including their breeding herd, **by maintaining them in their inventory accounts.** Regulation Sec. 1.471-6 (f) . ." (Emphasis added). See Brief for the United States, in the Court of Appeals below, at p. 13.

44—The farmers in the **Wardlaw** case were "required by the Regulations next below mentioned to and did carry all their livestock raised and held for sale on the market, and also their raised . . and purchased livestock constituting their breeding herd and held by them for breeding purposes, on an inventory basis . . ." R. p. 67, Par. 5.

45—The Ekberg case stated categorically that ". . Regs. 1.471-6(f) . . . provides that a taxpayer who elects to use the unit-livestock-price method must apply it to all livestock raised including breeding animals. This means that a livestock raiser who uses this method cannot segregate his raised breeding herd and treat it as though it were a capital asset subject to depreciation . . ." United States v. Ekberg, supra, p. 917, fn. 5.

Having argued the case in the courts below on the ground that the accrual method farmer using the unit-livestock-price method of valuing his inventories was required by Reg. 1.471-6 (f) to include his raised breeding animals in inventory along with his livestock held for sale to customers in the ordinary course of business, and that the **Lewis** case was wrong when it stated that the regulation requiring such inclusion was invalid as to the taxpayer before that court, **the Petitioner now takes the position that "the Regulations do not require" a livestock farmer "to include raised breeders in inventory . . ."** Brief, p. 30, footnote 19.

Respondent does not profess to know what has motivated Petitioner to shift his position, and alter his argument, in this manner. Perhaps he has had an "eleventh-hour" conversion to the belief that if Reg. 1.471-6(f) is construed to mean that livestock farmers using the unit-livestock-price method of valuation are required to put their raised breeding animals in inventory along with livestock held for sale to customers then such regulation would be invalid as against **all** livestock farmers, not just those who had no "meaningful choice" in the matter.

Whatever the reason for this shift from his position in the courts below, the Petitioner now advances a new construction of Reg. 1.471-6 (f). His new contention seems to be that while "the Regulations do not require"[46] the inclusion of raised breeding animals in inventory, Reg. 1.471-6 (f) does require that farmers "who have chosen the unit-livestock-price method of valuing their inventory of beef cattle", i.e., livestock held for sale to customers in the ordinary course of business, must capitalize the cost of feeding and rais-

46—Brief, p. 30, fn. 19.

ing their breeders.[47] Presumably, this means that the farmer using the unit-livestock-price method of valuing his animals held for sale must capitalize the raising costs of his breeders even though he has not chosen to put the breeders in inventory.[48] Since, as we have seen, and as Petitioner admits, the net effect of requiring breeders to be included in inventory is to force a capitalization of the costs of feeding and raising the breeders, then it is obvious that requiring the capitalization of the raising costs of breeders even

47—Brief, Pages 30, 32. In stating this new construction of Reg. 1.471-6 (f), Petitioner for some reason avoids saying that the farmer must "capitalize" his raising costs; instead he says that the costs ought to be "deferred rather than deducted". Brief, p. 32. It may be that he feels that this sounds better because it leaves the clear suggestion that although these costs can't be deducted as a current expense right now (even though Reg. 1.162-12 provides that they can) they are simply being deferred, and will be allowed later as a deductible expense. This, of course, is far from the truth, and Petitioner knows it. These raising costs, if allowed to be deferred in this manner, will never be allowed as an expense deduction! They will only be allowed as basis in computing gain when the breeding animal is sold. This is the same thing as telling a business man that his business expenses will not be allowed as deductible business expenses, but not to worry because they will be allowed as basis when he sells his business!

48—If, as may be the case, in view of his having retreated from the view that a farmer using the unit-livestock-price method for valuing his animals held for sale must include his raised breeders in inventory, the Petitioner's new construction of Reg. 1.471-6 (f) does not mean to require the capitalization of raised breeding animals which the farmer has chosen not to put in his inventory, but means that the farmer who elects this method for his livestock held for sale must capitalize the raising costs of his breeding animals only if he has included these animals in inventory, then the substance of the Petitioner's new position is that if a farmer elects to use the unit-livestock-price method for his animals held for sale he is not required to include his breeders in inventory (which inclusion, we have seen and the Petitioner has admitted, would be the equivalent of requiring the capitalization of the raising costs of the breeding animals) or to capitalize the raising costs of his breeders unless he elected to put them in inventory. This would give the farmer an option at the time he elects to use the unit-livestock-price method, either to put his breeders in inventory or to leave them out; and if he left them out he would not have to capitalize their raising costs. Respondents would not object to this interpretation of Reg. 1.471-6 (f), because the option would make the regulation fair. However, even under this interpretation of the Petitioner's new construction of Reg. 1.471-6 (f), the Respondents in the **Wardlaw** case would not be controlled by this Regulation because they had no such option when they were forced to adopt the unit-livestock-price method in 1944 because at that time the Regulation was construed to mean that farmers using the method **must** include their raised breeding animals in inventory.

though they have not been included in inventory is exactly the same thing as requiring that the breeders be included in inventory! Therefore, while this new statement of his position by the Petitioner may be considered clever semantics, actually it only serves to emphasize the fact that Petitioner is violating his own long-standing Reg. 1.162-12. His argument in the District Court and the Court of Appeals below, to the effect that raised breeders must be included in inventory, violated Reg. 1.162-12 because the net effect of the inclusion was to require a capitalization of raising costs. His new argument violates Reg. 1.162-12 directly by saying that raising costs of all breeders, whether in or out of inventory, must be capitalized, and therefore the violation is more apparent.[49]

49—It is difficult to be really sure what the Petitioner's contentions are in this case. He began by saying that farmers who elected the unit-livestock-price method were required by Reg. 1.471-6 (f) to include their raised breeding animals in inventory. He now says this is not required, but that the regulation in question does require a farmer electing the unit-livestock method to capitalize the costs of raising his breeding animals. Br. pp. 30, 32. He does not say whether this includes raised breeding animals which have not been included in inventory. Presumably it does. Finally, he says that ". . . the legislative history and statutory reenactment which prevent the Treasury from amending the Regulations relating to cash method ranchers also give the effect of law to the Regulations requiring accrual method ranchers to capitalize the costs of raising breeding animals." This is a thoroughly misleading statement for the following reasons:

(1) His first reference to "the Regulations" in the above-quoted sentence is undoubtedly Regulation 1.162-12, and he leaves the impression that it relates to cash method ranchers alone. This is not true, because it clearly relates to accrual method ranchers as well as cash method ranchers. See letter from the Secretary of the Treasury, above-quoted, which states that the right to deduct raising costs as a current expense is a right which has been extended to all livestock farmers since the early days of the income tax.

(2) In his second reference to "the Regulations", he is probably referring to Reg. 1.471-6 (f), or he is referring to some other section of the Regulations. But in either event he is leaving a false impression when he states that "the Regulations" require "accrual method ranchers" to capitalize the costs of raising breeding animals. The reason is that there is no provision in any of the Commissioner's regulations which contains the general requirement that "accrual method ranchers" must capitalize the costs of raising breeding animals. The nearest thing to any such requirement is the regulation which has caused the controversy now before this Court, namely, Reg. 1.471-6 (f), and that regula-

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IV

It is not necessary for the farmers in the Wardlaw case to obtain the consent of the Commissioner in order to remove their raised breeding animals from inventory and to continue to deduct the cost of raising these breeding animals as a current expense.

The Petitioner contends that the farmers in the **Wardlaw** case, regardless of any other factors, must obtain his consent before they can remove their raised breeding animals from inventory. This argument was advanced in the **Lewis** case, but the **Lewis** case found the removal was not a change of accrual method, and furthermore, that consent was not necessary because the Regulation requiring the inclusion was invalid as to the taxpayer before that court since he had not been afforded a "timely option" when he had to select his accounting and inventory valuation method.[50]

This same argument was also advanced in the **Ekberg** case, where the court, in effect, said that the argument was sound as to the taxpayer there before the court because such taxpayer had had a meaningful choice when he selected the accrual method of accounting and the unit-livestock-price method of inventory valuation, and was therefore bound by his election.

In both of the instant cases now before this court, **Wardlaw** and **Catto,** the Court of Appeals found, as it did in the **Lewis** case, that withdrawal of these animals from inventory, because the animals had been put there in the first place by reason of a Regulation that

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tion is confined to accrual method ranchers **who elect to use the unit-livestock-price method.**

This sort of loose treatment of the controversy now before this Court is not designed to persuade, but merely misleads.

50—United States v. Ekberg, supra, p. 9.

was invalid as to the taxpayers before the court, did not require the consent of the Commissioner.

The taxpayers in the **Wardlaw** case, when the new Regulations in 1944 for the first time offered livestock farmers the farm-price method of inventory valuation and the unit-livestock-price method, were required by the Regulations to "elect" the unit-livestock-price method, which in turn required the inclusion of raised breeders in inventory, according to the Commissioner's then construction of that Regulation. Save for being thus locked in to the unit-livestock-price method, the taxpayers in the **Wardlaw** case could have selected the farm-price method, which does not require the inclusion of raised breeders in inventory. **Therefore, the raised breeders belonging to the farmers in the Wardlaw case were in inventory in the years now under consideration only because the Commissioner construed Reg. 1.471-6 (f) to require it.** The Commissioner now says that this Regulation does not require such inclusion, but he makes the incredible argument that even though, during the years in question, the taxpayers put their raised breeders in inventory because he told them they had to, under Reg. 1.471-6 (f), and even though they could have left the animals out of inventory, beginning in 1944, but for being locked in to the unit-livestock-price method by the Regulations, nevertheless they cannot now remove their raised breeding animals from inventory without his consent, and this he will not give.

While the Commissioner has a general right to require a taxpayer to obtain his consent before there is a material change of accounting method, this right cannot be exercised in an arbitrary manner, nor be used to override or circumvent a statute. In the instant case, the Commissioner occupies the insupportable position of having told the taxpayers in this case, by

his construction of Reg. 1.471-6 (f), that they had to include their raised breeding animals in inventory; and then when they did so he seeks to make them keep their raised breeding animals there on the ground that they have not obtained his consent to remove them. This is an obviously arbitrary refusal, and a complete distortion of the use of the authority to require consent.

Moreover, the taxpayers in the **Wardlaw** case have every right to follow the specific prescription of Reg. 1.162-12, which Petitioner admits has attained the effect of law, and take a current expense deduction for the cost of feeding and raising their breeding animals. This cannot be done unless the animals are removed from inventory, because the inclusion of the animals in inventory negatives or neutralizes any deduction of raising costs. It is submitted that consent of the Commissioner is not required in order for a taxpayer to adjust his bookkeeping in order to follow the explicit language of Reg. 1.162-12.[51]

51—If the Commissioner can, by the exercise of his general authority to require taxpayers to obtain his consent before materially changing their accounting method, require that the farmers in the **Wardlaw** case not deduct their raising costs as a current expense, but instead capitalize them, despite the fact that the right to deduct is expressly given by a regulation which has attained the effect of law, this would seem to constitute the grossest sort of administrative abuse by the Commissioner. For instance, suppose Congress passed a law which said expressly that accrual method farmers may deduct the raising costs of their breeders and may pay capital gains taxes only on the proceeds from the sale of these raised breeders. This would be a permissive statute, not providing what the farmer **must** do, but providing what he **may** do. If the Commissioner did not like this legislation, he could simply say to the farmers that, in order to deduct your raising costs and take capital gain on the proceeds of the sale of your raised breeders, you would be changing your accounting method by changing your previous handling of this item of raising costs, and your previous handling of the item of proceeds from the sale of your raised breeders; and that therefore you need my consent, and I refuse to give it. Surely no court would approve this sort of procedure by the Commissioner, whereby the Commissioner puts himself above the law and above the will of Congress. In the instant **Wardlaw** case we have exactly that situation, except that the provision giving the right to the livestock farmer to deduct his raising costs as a current

Finally, a general provision giving the Commissioner the right to require consent before a material change of accounting method must always yield before specific statutes, such as Reg. 1.162-12. See **North Carolina Granite Corporation v. Commissioner,** 43 T.C. 149, at p. 168, and cases there cited.[52]

V

Principal Fallacies In Petitioner's Three Arguments

Petitioner's first argument is that

> "The dichotomy between cash and accrual method ranchers is supported by sound accounting practices and by history, and has been approved by Congress." Brief. p.8.

No doubt the dichotomy to which the Petitioner refers is the dichotomy, or difference, in treatment of the cash method farmer and the accrual method farmer on the subject of r a i s e d breeding animals.[53]

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expense is given by a 45-year old Regulation, which through process of statutory re-enactment has achieved the effect of law. It is therefore submitted that there is no justification whatever for saying that the consent of the Commissioner is necessary to allow these farmers to remove their raised animals from inventory and thereby be enabled to deduct the cost of raising their breeders as a current expense rather than be forced to capitalize such cost by including their raised animals in inventory.

52—When the farmers in this case sought to remove their raised breeding animals from inventory they did not seek the consent of the Commissioner, because the Commissioner, as has been stipulated, was not even considering applications from livestock raisers to withdraw raised breeding animals from inventory (which he considered to be a change of accounting method) until after the 1954 Regulations were promulgated, which was by Treasury Decision 6366 on February 19, 1959, Stip. 31, R. 77.

53—The Respondents have never questioned the fact that there is a difference in timing, as between the accrual method farmer and the cash method farmer, as to all income and disbursements.

If so, it is submitted that sound accounting practices do not support the Commissioner when he permits a livestock farmer using the **cash method** of accounting to deduct the cost of feeding and raising his breeding animals as current expenses, and then turns around and tells the **accrual method** farmer that these very same raising costs must be capitalized.[54] Under sound accounting practices, the difference between the cash method and the accrual method is one of timing only, and this does not mean the same item is to be expensed under one method and capitalized under the other!

It is further submitted that Reg. 1.162-12, and its predecessors, have explicitly provided, for over 45 years, that **livestock farmers are entitled to deduct the cost of feeding and raising breeding animals as a current expense.** This regulation applies to all livestock farmers, as the Secretary of the Treasury said in 1952,[55] and not just to farmers using the cash method of accounting. To deny this current expense deduction to accrual method farmers by requiring them to capitalize, rather than expense, their raising costs, is a flat rejection of the rights created by this long-accepted regulation. This regulation has assumed the force and effect of law by repeated re-enactment of the statute under which it was promulgated, and the regulation has remained unchanged for 21 years be-

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54—Even the Secretary of the Treasury has said that this difference in treatment, as between the cash method farmer and the accrual method farmer "discriminates heavily" against the accrual method farmer. See letter to the chairman of the Senate Finance Committee, R. p. 9 at p. 12.

55—". . . since the early days of the income tax, the regulations have permitted farmers to take current expense deductions for the cost of raising livestock intended for . . breeding . . purposes." Letter from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, cited supra.

fore and 23 years since the enactment of Section 117 (j), for 22 years since I.T.3666 was issued, and for 14 years since the enactment of Section 1231 of the Revenue Act of 1951. It is significant that Petitioner failed to explain, or even cite, Reg. 1.162-12 in his Brief or in his Reply Brief, before the Court of Appeals below; but when the existence of the regulation was repeatedly pressed upon him by Respondents, Petitioner finally acknowledged that the regulation existed but asserted that an accrual method farmer was not entitled to expense his raising costs under the regulation because the Commissioner had given the word "may" in the regulation[56] "an administratively circumscribed compass" so as to deny the expense deduction to accrual method farmers, although as a matter of "administrative expediency" the cash method farmer was allowed to deduct these same raising costs as a current expense. See Reply Brief of the United States to the Supplemental Brief for Appellee-Cross Appellants, in the Court of Appeals, W. H. Wardlaw, et al, page 4.

It is submitted that giving the word "may" "an administratively circumscribed compass" is scarcely an acceptable reason for denying to accrual method livestock farmers the right expressly granted by Reg. 1.162-12 to **all** livestock farmers. The fact is that Reg. 1.162-12 is so clear and explicit on the point that the costs of feeding and raising livestock constitute "current expense deductions" that there is no way to justify a denial of the expense deduction to **any** livestock farmer.

56—"The purchase of feed and other costs connected with raising livestock may be treated as expense deductions . ." Reg. 1.162-12.

B. Petitioner's second argument is that

> "There is no merit to Respondents' claim that they have a right to use a hybrid accounting system because they elected the accrual method before the advent of capital gains on breeding animals." Brief, page 18.

Respondents are now using the accrual method of accounting and they expect to continue to use it. They are not seeking to switch to the cash method of accounting, as Petitioner admits.[57] Nor are Respondents asking to use a hybrid accounting method. For the reasons set forth hereinabove, they simply ask that (1) they not be required to keep their raised breeding animals in inventory where, Petitioner now admits, there is no obligation to keep them, and (2) that they be permitted to continue taking the cost of feeding and raising their breeding animals as a current expense (as permitted by Reg.1.162-12) and not be required to capitalize these expenses.

Petitioner takes the position that the farmers in the **Wardlaw** case cannot remove their raised breeding animals from inventory because they elected the accrual method of accounting and the unit-livestock-price method of inventory valuation. Of course, there is nothing in the accrual method of accounting or in the Regulations covering the unit-livestock-price method of inventory valuation that says a farmer must include his raised breeding animals in his inventory. This the Petitioner admits. Probably the Petitioner would now agree that the farmers in the **Wardlaw** case are entitled to remove their raised breeding animals from inventory. But immediately this is done the Petitioner would claim that because these farmers chose the unit-livestock-price method of inventory valu-

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57—"... respondents do not . . seek to switch from the accrual to the cash method of accounting." Brief, p. 23.

ation, these animals should be set off separately from inventory and be given a basis equal to the cost of feeding and raising these animals, in other words, that their raising costs must be capitalized. This then is what the parties are now contending about before this Court. Simply stated, the issue is: Must a livestock farmer who has **chosen** the unit-livestock-price method of inventory valuation capitalize the cost of raising his breeding animals, whether he has put them in inventory or not?

The answer of the Respondents in the **Wardlaw** case to this question is as follows:

(1) **The Respondents in the Wardlaw case did not elect or choose the unit-livestock-price method. It was forced upon them by the Regulations.** As pointed out in detail hereinabove, the unit-livestock-price method was first offered to farmers in 1944 by the amendment to the Regulations. This amendment made two valuation methods available: the farm-price method and the unit-livestock-price method. However, this same amendment also stated that a farmer who, prior to 1944, used a constant unit price method of valuing inventory, "will be considered as having elected" the unit-livestock-price method. The farmers in the Wardlaw case fell into this category, and hence were locked into the unit-livestock-price method as soon as it was offered. Obviously they did not voluntarily elect the method.[57A]

(2) Under the **Ekberg** meaningful choice doctrine, farmers will be bound by their choice of the accrual method and the unit-livestock-price method of valu-

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57A—If the farmers in **Wardlaw** had not thus been locked in to the unit-livestock-price method by the Regulation, they could have elected the farm-price-method, left their breeders out of inventory, and thus avoided all of the hardship of this litigation.

ing inventories only if, when they made the choice, it was "meaningful". The thrust of the **Ekberg** case is simply that if you are going to bind a taxpayer because of a prior election or choice, then you must find that the taxpayer knew, or should have known, what the available choices were and the tax consequences which would flow from each. The **Ekberg** case concluded that where a taxpayer had to make his choice prior to 1944, then such a choice could not be "meaningful" because it was only by I.T. 3666, published in 1944, that the Commissioner of Internal Revenue recognized that capital gains treatment under Section 117 (j) was available on the sale of breeding animals.[58]

(3) Respondents decided many years ago, long before 1944, at the time they adopted the accrual method of accounting, that they would use a constant unit price method in valuing their inventories. There was no regulation providing for this, it was simply an informal practice commonly followed by livestock farmers. But this method was not the unit-livestock-price method of 1944, and subsequent years,

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58—By the same token, the decision of the farmers in the **Wardlaw** case to put their raised breeding animals in inventory was not a "meaningful choice". This choice was made many years prior to 1944, just as their selection of the accrual method of accounting was made many years prior to 1944. Therefore, this election to put their raised breeders in inventory was no more a "meaningful choice" of available alternatives than was their selection of the accrual method of accounting. During these early years, inclusion of raised breeding animals in inventory brought precisely the same tax consequences as leaving them out, and this fact remained true all down through the years until Congress saw fit to extend capital gains treatment to raised breeding animals. It would be thoroughly unjust to say that because the farmer put his raised breeding animals in inventory in 1913, or at any time prior to 1944, when it made absolutely no difference taxwise whether he did so or not, he ought now to be forbidden to discontinnue such inclusion and forbidden to remove his raised breeders from inventory, when the law has changed and it has become extremely important tax-wise, as to whether or not you carry your raised breeding animals in inventory.

which Petitioner, in the courts below, said required the inclusion of raised breeding animals in inventory, and now says requires the farmer to capitalize the cost of feeding and raising his breeding animals, whether he has chosen to include them in inventory or not. The constant price method elected by the Respondents many years prior to 1944 was obviously not the same as the unit-livestock-price method as construed by the Petitioner today. Consequently, it would be absurd to argue that the election of the constant-unit price method amounted to an election of the unit-livestock-price method.

C. Petitioner's third and last argument is that

> "The unit-livestock-price variant of the accrual method of accounting is an acceptable method of computing the amount of raising costs which are to be deferred pending sale of the animals." Br., page 25.

Since this supposed argument assumes the answer to the issues now before this Court, there is no argument to answer.

In his brief, Petitioner has argued that when an animal is born on the farm, and the farmer decides to keep the animal as an addition to his breeding herd, that paying the cost of raising that animal to maturity is the same as a manufacturer paying the price of purchasing or constructing a piece of business machinery. This analogy is more deceptive than helpful. The cost of greasing, oiling, servicing, and otherwise caring for a piece of machinery is obviously a deductible current expense, and will not be capitalized as part of the cost of purchasing or building the machine. In the same way, the cost of feeding, sheltering, medicating, and otherwise caring for the raised breeding animal is also a deductible current expense. The

Commissioner himself decided this to be true, as far back as the early days of the income tax[59]. The difference between the two cases is that the raised breeding animal is growing during this period after he is born, and will be worth more at maturity, three or four years later, than at birth. On the other hand, the machine will presumably be worth less three or four years later. Of course, if the machine is rare, or especially well built, or if prices are rising, it might well be that the machine could be sold later for more than it cost. If so, the increase in value would be capital gain, and meanwhile the owner of the machine has taken depreciation as a current deduction, and has taken a current deduction for greasing, oiling, servicing, and otherwise caring for the machine. But the Commissioner apparently feels that the farmer should not be able to deduct his costs of feeding, sheltering, medicating and otherwise caring for the breeding animal, and receive capital gain when the animal is sold after its useful life. Therefore, the Commissioner fights the accrual method farmer using the unit-livestock-price method for valuing his inventories, although he has given up as to the cash method farmer and apparently would not fight against an accrual method farmer using the farm price-method of valuing his inventory.

Frankly, it is difficult to understand exactly why the Commissioner has made such a crusade of this matter of raised breeding animals. There are other areas in tax law where essentially the same situation exists, and the Commissioner has shown no reluctance in permitting current expense deductions and subsequent capital gain treatment. For instance, in the case of growing fruit trees the cost of caring for and main-

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59—When the original version of Reg. 1.162-12 was adopted.

taining the trees during their growth and development period is permitted as a current expense deduction, and when the trees, or orchard, are sold the gain is capital gain. The Commissioner has never challenged this deduction, and yet the only difference between the orchard farmer and the farmer raising breeding animals is that there is more likelihood that the farmer will sell his breeding animals than that the farmer will sell his orchard.[60] This is a point of difference, but it is certainly not ground for distinguishing the two cases. Another situation where the deduction of current expenses is permitted, even though such expenses directly build up the value of a capital asset, is the very common situation where goodwill (an intangible property) is an important element in an incorporated business, and is cultivated and developed and increased in value as the result of spending which is deducted as a current business expense; thereafter the corporation is sold, and the seller receives capital gain on the sale of the business, including the good-will which has been increased in value by virtue of the deducted expenses. Still another case would be where a taxpayer buys a motel, and then through advertising and promotion, and other deductible business expenses, builds up the popularity of the motel; as a result, the motel is now worth, and can be sold for, considerably more than when it was built, the increased value, taxable at capital gain rates, being directly traceable to the funds spent, and currently deducted, on advertising, promotion, etc. Both of these latter cases, like the orchard case, differ from the raised breeding animal situation in that there is more likelihood that the raised animal will be sold than it is that the business or motel will be sold. But again, this is not ground

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60—Actually, peach orchards are frequently sold, and the gain is capital gain.

for distinguishing the cases, because the principle involved is the same.

Despite the foregoing the Commissioner continues to fight the raised breeding animal situation. This reluctance by the Commissioner to extend the full benefit of Section 1231 to breeding stock was noted first in the **Ekberg** case.[61]

CONCLUSIONS

Respondents submit that they have every right to remove their raised breeding animals from inventory, because by requiring Respondents to keep them there the Commissioner, as the Petitioner admits, is forcing them to capitalize the cost of feeding and raising these animals when the Commissioner's own long-standing Reg. 1.162-12, which Petitioner admits has attained the force and effect of law, provides that such costs are deductible as current expenses.

If, after removing these breeding animals from inventory, Respondents are entitled to receive capital gains treatment on the subsequent sale thereof, that is because Congress has seen fit to give them this privilege, and it is not within the province of the Commissioner to take it away, directly or indirectly.

Despite the foregoing, Petitioner now contends that if a farmer has elected, or "chosen", B. p. 32, the unit-livestock-price method of valuing his animals held for sale, he must capitalize the cost of raising his breeding animals, whether he has chosen to carry these breeding animals in inventory or not. On this ground, Petitioner would deny Respondents' claim to remove these breeding animals from inventory. This contention is specious (1) because the Respondents in the **Wardlaw** case nev-

61—United States v. Ekberg, supra,, p. 923.

er elected the unit-livestock-price method, but were forced by the Regulations to adopt same, and (2) because **any** Regulation that forces the farmer to capitalize the costs of feeding and raising his breeding animals is invalid because it violates Reg.1.162-12, which through the process of statutory re-enactment has attained the force and effect of law, and (3) because it is fundamentally unsound to contend that the cost of feeding, sheltering, medicating and otherwise caring for and raising an animal, whether he is in his growth period or not, is other than an ordinary and necessary expense of the farm operation. If there were any substance to the contention that these raising costs are equivalent to the cost of acquiring or building a capital asset, then why hasn't the Commissioner long ago told the cash method farmer that he must capitalize such costs? Surely the Commissioner knows that the acquisition cost of a capital asset must be capitalized by a cash method taxpayer as well as an accrual method taxpayer. The Regulations have for 45 years stated that the cost of raising breeding animals is a current expense deduction, and therefore cannot also constitute capital costs; there is simply no way the Commissioner can take a different position on this without new legislation.[62]

62—The relief asked by the Respondents in the **Wardlaw** case and granted by the courts below, is designed simply to put them in the position they would have been in had they not been required to include their raised breeding animals in inventory or to capitalize their raising costs. Clearly these farmers are entitled to a refund of the taxes they had to pay by virtue of the Commissioner requiring them to keep their raised breeding animals in inventory when they sought to remove them. The years for which relief is asked are 1957, 1958 and 1959. The only way to accomplish this relief is to remove all raised breeding animals from inventory at the close of the earliest year open under the Statute of Limitations, which year is 1957. This means that the ordinary income of these farmers will be reduced by an amount exactly equal to the ordinary income which was improperly created by the inclusion of their raised breeding animals in inventory. This relief will only be for raised breeding animals

(Continued on next Page)

It is respectfully submitted that the judgment of the Circuit Court of Appeals with respect to raised breeding animals should be affirmed.

Respectfully submitted:

CLAIBORNE B. GREGORY

ELWOOD CLUCK

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born in 1957 or later, or born before 1957 but still in inventory at the close of that year. Because of the Statute of Limitations, no relief whatever is available for the 13 years (1942-1956) of ordinary income tax unlawfully extracted on account of animals born, raised and sold prior to 1957.

APPENDIX A

Revenue Act of 1942, c.619, 56 Stat. 798.

§151. Real property; Involuntary conversions; etc.

(b) Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business. Section 117 (relating to capital gains and losses) is amended by inserting at the end thereof the following new subsection:

"(j) Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business

"(1) **Definition of property used in the trade or business.** For the purposes of this subsection, the term 'property used in the trade or business' mean property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

"(2) **General rule.** If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and

losses shall be considered as gains and losses from sales or exchange of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

"(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

"(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion."

Revenue Act of 1951, c.521, 65 Stat. 452.
Sec. 324 Sales Of Livestock

Section 117(j) (1) is hereby amended by adding at the end thereof the following new sentences: "Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry." The first sentence added to section 117(j) (1) by the amendment made by this section shall be applicable with respect to taxable years beginning after December 31, 1941, except that the extension of the holding period from 6 to 12 months shall be applicable only with respect to taxable years beginning after December 31, 1950. The second sentence added to section 117(j) (1) by the amendment made by this section shall be applicable only with respect to taxable years beginning after December 31, 1950.

Reg. 111, Sec. 29.22(a)-7. Gross income of farmers—A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of livestock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which were purchased after February 28, 1913, is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income.

In the case of a farmer reporting on the accrual basis (in which an inventory is used to determine profits), his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the cost of live stock and products purchased during the year. In such cases all live stock raised or purchased for sale shall be included in the inventory at their proper valuation determined

in accordance with the method authorized and adopted for the purpose. Also live stock acquired, for draft, breeding, or dairy purposes and not for sale, may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. (See section 29.22(c)-6.

REG. 111, SEC. 29.23(a)-11 Expenses of farmers. —A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see section 29.41-2), be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. Amounts expended in purchasing

work, breeding, or dairy animals are regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with section 29.22(a)-7. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. (See also sections 29.22(a)-7, 29.23(e)-5 and 29.23(1)-10.)

Reg. 111, Sec. 29.22(c)-6 (As amended by T.D. 5423, Dec. 15, 1944). Inventories of livestock raisers and others farmers. * * *

Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory basis may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

The "farm-price method" provides for the valua-

tion of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in section 29.41-2.

The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuating his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: calves, $15; yearlings, $22.50; two-year old, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the Commissioner upon examination of the taxpayer's return.

A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of

animals or unit prices will be made without the approval of the Commissioner.

A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for breeding, dairy, or draft purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each accounting year in accordance with the established unit prices, except that no increase is to be made in the year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in first-out method of valuing inventories must be applied.

If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in section 29.41-2. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock for taxable years beginning after December 31, 1943 without formal application for permission, but the classifications and unit prices selected are subject to approval by the Commissioner upon examination of the taxpayer's return. A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on

that basis will be considered as having elected the "unit-livestock-price method".

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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, PETITIONER

v.

JOHN CATTO, JR., AND ROXANA CATTO

UNITED STATES OF AMERICA, PETITIONER

v.

W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. W. WARDLAW, DECEASED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

I

All parties agree that the basic question here is whether or not an accrual method rancher can properly be required to defer (*i.e.*, capitalize) the costs of raising breeding animals and deduct such accumulated costs against the proceeds derived from their

sale.[1] See, *e.g.*, *Wardlaw* br., p. 43. Respondents argue that they need not accumulate the costs of raising breeders because Code § 1231 forbids it.[2] In enacting that section, they assert, Congress meant to give accrual method ranchers capital gain treatment on the full proceeds received from sales of breeding animals. To the contrary, § 1231 grants capital gain treatment only to the "gains" recognized on sales of breeding livestock, and the word "gain" typically means the excess of sales proceeds over the accumulated cost (or other basis) of an asset rather than the full sales proceeds. See, *e.g.*, 1954 Code §§ 1001(a), 1012. Taxpayers have always been required to accumulate, until the time of sale, the costs of production. This is so whether they are on the cash or accrual method, whether the products are included in inventory (1954 Code §§ 471, 1013; Treas. Regs. § 1.471–1) or are capital assets (1954 Code §§ 263, 1016(a)(1); Treas. Regs. § 1.263(a)).[3] Indeed, the Regulations dealing specifically with ranchers and farmers (promulgated in the early 1920's and carried forward to the present substantially verbatim) have always required accrual method ranchers to accumulate the costs of raising livestock.

In the early 1920's the Commissioner recognized that many farmers and ranchers were not capable of

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[1] This question applies equally to all accrual method ranchers, regardless of whether they are on the unit-livestock-price method, the farm-price method, or some other variant of the accrual method of accounting, and regardless of whether or not they have chosen to include breeding animals in inventory.

[2] All citations to the Code or Treasury Regulations refer, unless otherwise stated, to the Internal Revenue Code of 1954 and the Regulations promulgated thereunder.

[3] See also, *e.g.*, I.T. 1309, I–1 Cum. Bull. 196 (1922).

valuing cattle on hand and deferring costs properly allocable to them. Therefore, in order to afford them an extremely simple method of accounting, the Commissioner relaxed the general rule requiring all taxpayers to accumulate the costs of constructing or creating assets. Pursuant to his authority to promulgate and define methods of accounting,[4] he permitted farmers and ranchers who elected the *cash* method to deduct the costs of raising crops or livestock as incurred.[5] However, it is quite clear that as to those farmers and ranchers who elected the *accrual* method of accounting, the Regulations did not deviate from the general rule requiring all taxpayers to defer the costs of constructing or creating either inventory or capital assets. Indeed, to have done so would have upset the accrual method as a more accurate alternative to the simplified cash system.

As is frequently the case in the Income Tax Regulations the Commissioner did not enunciate in one place all of the rules governing the two methods of farm and ranch accounting. In part the rules are set forth in the portion of the Regulations dealing with income;[6] the remainder appear among the Regulations dealing with deductions.[7] Although both sets of rules were obviously meant to be read together, respondents persist in citing only that portion concerned with deductions and ignore the one dealing

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[4] See, *e.g.*, 1954 Code §§ 446, 471, 7805, and their predecessors.

[5] Regulations 65, Arts. 38, 111 (1924 Revenue Act); 1954 Treas. Regs. §§ 1.61–4, 1.162–12.

[6] Regulations 65, Art. 38 (1924 Revenue Act); 1954 Treas. Regs. § 1.61–4.

[7] Regulations 65, Art. 111 (1924 Revenue Act); 1954 Treas. Regs. § 1.162–12.

with income. The Regulations provide a two-step procedure: First, the part dealing with deductions provides that, in general, "The purchase of feed and other costs connected with raising livestock may be treated as expense deductions." Second, the Regulation dealing with the computation of income provides (a) that a *cash* method rancher need make no adjustment on account of costs incurred in raising livestock which are still on hand at the year end (*i.e.*, that the *cash* method rancher need not reduce the deduction allowed by the first Regulation discussed above), and (b) that an *accrual* method rancher, on the other hand, must add to income the amount of the increase in the raising costs attributable to such animals still on hand (*i.e.*, he must reduce the deduction allowed by the first Regulation discussed above by this amount).

The reason that accrual method ranchers are first given a deduction for raising costs and are then required, in effect, to offset the deduction by adding to income the increase in the cost (or estimated cost) of their livestock on hand is because this two-step procedure automatically performs the difficult task of allocating the various ranch and farm expenses (such as feed, labor, etc.). See our initial brief, pp. 11, 26–30. The parties agree that the net effect of these Regulations is properly to require accrual method ranchers to accumulate the costs of raising their *inventory* animals. See, *e.g.*, Stipulation of Facts, R. 67–70, 3–5. At the time these Regulations were originally promulgated, accrual ranchers included their

breeding animals in inventory for accounting convenience. Therefore, the Regulations provide that, if an accrual method rancher wishes, he may consistently include his breeding livestock in inventory, but that, if he does not elect to do so, they shall be "treated as capital assets subject to depreciation." Regulations 65, Art. 38 (1924 Revenue Act); 1954 Treas. Regs. § 1.61–4(b). If an accrual rancher elects to keep his breeders in inventory, he is thus required to offset that part of the "deduction" for raising costs attributable to such animals on hand at year-end. If, on the other hand, he elects to treat them as "capital assets" he is subject to the general rule requiring accumulation of the costs of creating or constructing a capital asset (see *supra,* p. 2), in which case he must similarly offset that portion of the "deduction" for raising costs attributable to increases in the estimated cost basis of breeders on hand.[8]

[8] At numerous places in their briefs respondents make statements to the effect that the Commissioner's position would require them to recognize part of the increase in value of breeders as ordinary income each year. See, *e.g.*, *Wardlaw* br., pp. 5, 13, 20; *Catto* br., pp. 3–4. As respondents readily recognize at other places in their briefs, the Commissioner's position in the instant cases does not in fact create any ordinary income on account of breeders; viewing both the income and the deduction portions of the Regulations together, their net effect is merely to create and then offset the accrual ranchers' deduction for the costs of raising breeders, and thus to defer the raising costs until the animals are sold, at which time the accumulated costs are deducted against the sales proceeds in computing gain. See, *e.g.*, *Wardlaw* br., pp. 6, 9, 20–22, 29, 34–35, 42–43.

Respondents concede that accrual ranchers must accumulate costs incurred in raising beef (inventory) animals. Stipulation of facts, R. 67–70, 3–5. They nevertheless argue that accrual ranchers are not required to accumulate the same type of raising costs when incurred in connection with breeding animals. But the Code provides that "No deduction shall be allowed for * * * [a]ny amount paid out * * * to increase the value of any property" (1954 Code § 263), and that such expenditures shall instead be added to the cost basis of the property (1954 Code § 1016(a)) and deducted against the proceeds received upon sale of the property in order to compute gain or loss (1954 Code §§ 1001(a), 1012). The Regulations make it clear that a taxpayer must capitalize the costs of producing or constructing "machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year." Treas. Regs. § 1.263(a)–2. The costs of raising a breeding animal from birth to maturity (when it is put in service) are, for this purpose, equivalent to the costs of constructing a piece of machinery or equipment.[9] Respondents are thus re-

[9] Respondents argue that since the expenses of feeding and caring for *mature* breeding animals are deductible as incurred, the same type of expenses when incurred in raising immature breeders must also be deductible. However, it is clear that certain costs must be capitalized when incurred in constructing a machine (such as for small parts and lubricants), while similar costs incurred in regularly maintaining the machine after it has gone into service are currently deductible. See Treas. Regs. § 1.162–4.

Respondents also argue that the fact that *cash* method ranchers are permitted to deduct the costs of raising breeders

quired to defer, until sale, the costs of raising breeding animals, regardless of whether they choose to include their breeders in inventory or treat them as "capital assets."[10] Treas. Regs. § 1.61–4(b). The principal difference between including breeders in inventory and treating them as "capital assets" is merely one of accounting mechanics, since both achieve the same result.[11]

Moreover, the Regulation defining the unit-livestock-price method of valuing livestock, promulgated

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prove that such raising costs are not the type of expenditures that § 263 would require a taxpayer to capitalize. However, as explained *supra*, p. 3, the Regulations, in order to create a special simplified method of accounting for farmers and ranchers, have deviated from the usual capitalization requirement with regard to raising costs incurred by *cash* method farmers and ranchers.

[10] Certainly the Regulation does not, as respondents suggest (*Wardlaw* br., p. 34, fn. 48), require an accrual method rancher to accumulate the costs of raising breeders if he elects to include them in inventory, but not if he chooses to treat them as "capital assets." Such a rule would not effectuate the Commissioner's manifest purpose in promulgating the Regulations here in question, that is, to create a simplified cash method of accounting for ranchers and farmers who wish to deduct the costs of raising their crops and livestock as incurred and a more accurate method for ranchers who were both willing and able to maintain sufficient records to accumulate the costs of raising their animals and match such costs against the income they produce.

[11] Contrary to respondents assertion (*Wardlaw* br., p. 39, fn. 52), there is no stipulation that the Commissioner would not permit ranchers to remove their raised breeders from inventory. However, even if respondents had asked for and obtained such permission, they would nevertheless have been required to accumulate the costs of raising breeding animals. Respondents admit that this would be the result if the Commissioner's position in the instant case prevails. *Wardlaw* br., pp. 42–43.

in 1944, confirms the conclusion that the 1924 Regulations required all accrual method ranchers to accumulate the costs of raising breeders. It provides that any rancher who has elected the unit-livestock-price method of valuation "must apply it to all livestock raised, whether for sale or for * * * breeding * * * purposes" (Treas. Regs. § 1.471–6(f), *i.e.*, he must use this estimated-cost method to value both his beef and his breeding animals, irrespective of whether, for accounting convenience, he has elected to include his breeders in inventory.[12]

When Congress in 1951 amended the predecessor to § 1231 of the 1954 Code to explicitly provide that "gains" from sales of breeders would be taxed as capital gain, it had before it all of the above mentioned Regulations as well as a published revenue ruling making clear that in computing the amount of "gain" from the sale of breeders an accrual method rancher would, pursuant to the usual rules for computing gains, deduct his accumulated costs of raising

[12] These Regulations also provide that after *purchasing* an immature breeding animal, the taxpayer must increase the animal's cost basis each year until maturity by the amount of his estimated costs incurred in raising the animal that year (according to his established yearly cost estimates). Treas. Regs. § 1.471–6(g). It is clear from the immediately preceding sentence of the Regulations that this rule is meant to apply regardless of whether the taxpayer has elected to include his purchased breeders in inventory, and that this rule requiring ranchers to accumulate the costs of raising immature *purchased* breeders is merely illustrative of the requirement that accrual method ranchers must accumulate the costs of raising all immature breeders, whether purchased or born on the ranch.

the animal, whereas a cash method rancher would (because of his simplified method of accounting) have no accumulated cost basis to deduct.[13] As discussed in detail in our initial brief, the Committee Reports accompanying the 1951 statutory amendment demonstrate that Congress recognized that accrual method ranchers would continue to deduct their accumulated raising costs in computing "gain."[14] Shortly thereafter Congress rejected a proposed amendment to the Code which would have altered the accrual ranchers method of computing gains and instead reenacted § 1231 verbatim in the 1954 Code.[15]

II

Respondents argue that they never elected the unit-livestock-price method, but that it was forced on them in 1944. This does not comport with the facts. We have shown that before 1944 the Regulations required accrual method ranchers to accumulate the cost of raising breeders. Most ranchers, including respondents, consistently used an estimated cost method known as the constant-unit or unit-price method to accomplish this result. In 1944 the Commissioner promulgated a Regulation formally recognizing that method of valuation (T.D. 5423, 1945 Cum. Bull. 70), and requiring those ranchers who, like respondents, had already begun using it to continue the practice. See Treas. Regs. § 1.471–6(h)

[13] See I.T. 3666, 1944 Cum. Bull. 270, discussed at pp. 14, 22 of our initial brief.

[14] See our initial brief, pp. 14–15, 22–23.

[15] *Id.*, p. 15.

and its 1939 Code predecessor, Treas. Regs. 111, § 29.22(c)–6. Inasmuch as all taxpayers who adopt a particular method of accounting for an item of income or expense, including inventory, must continue to report that item consistently unless the Commissioner grants permission to change (*Brown* v. *Helvering,* 291 U.S. 193; 1954 Code § 446(e); Treas. Regs. §§ 1.446–1(c)(2)(ii), (e)(2)(i), (e)(2)(ii), 1.471–2(b), (d), 1.471–6(a)), the 1944 Regulation required no more of respondents than they were already bound to do. Furthermore, the Commissioner has granted permission to switch from the unit-livestock-price method to other variants of accrual accounting, but respondents have never requested permission to change, undoubtedly because the unit-livestock-price method of livestock valuation is the most favorable method for taxpayers.[16]

III

Finally, respondents argue that even if accrual method ranchers have always been required to defer

[16] A rancher on the unit-livestock-price method defers an estimated amount of raising expenses which, as a matter of practice, is generally less than actual raising costs, and therefore he usually does deduct part of his raising costs as incurred. The farm-price method, which is the second most popular method of valuation, requires the farmer or rancher to value his crop or livestock "at market price less direct cost of disposition." Treas. Regs. § 1.471-6(d). Since this value would generally exceed the taxpayer's cost of raising the items, it would prevent him from currently deducting any of his raising costs and might result in some anticipation of income. The other available inventory methods, cost and the lower-of-cost-or-market, would also generally result in the taxpayer's deferring his full raising costs.

the costs of raising breeders, they should nevertheless be excused from this requirement because they had no "meaningful choice." Respondents evidently mean that at the time they chose between the simplified cash and the more accurate accrual methods of accounting, they did not know that the "gains" from sales of breeding animals would, after 1942, be taxable as capital gain rather than as ordinary income.

The short answer is that respondents may not revoke their election merely because a change in the law has altered the relative tax advantages of one method over another. "Tax statutes and tax regulations never have been static. Experience, changing needs, changing philosophies inevitably produce constant change in each. One making an election in [a previous] * * * return [takes] * * * the risk that the method of treatment of [an item] * * * might be changed by Congress, or, where power existed, by the Commissioner." *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 97 (where the Court rejected taxpayer's argument that a change in the law after it had elected between two methods of accounting invalidated the Regulations because it "had no free choice").[17] Similarly,

[17] See also *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, where the taxpayer in 1937 elected to report his gains from sales of land on the installment method of accounting. Thereafter (in 1940) Congress enacted an excess profits tax which, in general, applied only to a taxpayer's income in excess of 8% of his "invested capital." The Commissioner ruled that taxpayers on the installment method of accounting could not include their unrealized gains from past sales in their "invested capital," although those on different methods of accounting could. The Court upheld the validity of the regulations.

in the instant case, respondents, having elected the accrual method of accounting, "took the risk that the method of [taxing gain on the sale of breeding animals] * * * might be changed by Congress." [18]

Respectfully submitted.

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MARCH 1966.

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[18] Even assuming that there is merit to respondents' claim that they were denied a "meaningful choice," the only remedy to which they could be entitled is a new election, *i.e.*, an opportunity to make a "meaningful choice" between the cash and accrual systems of accounting. However, the respondents admit that "They are not seeking to switch to the cash method of accounting." *Wardlaw* br., p. 42. Respondents are attempting to use a hybrid method of accounting never authorized by the Commissioner, under which they could combine the advantages of the cash and accrual methods of accounting. This they may not do. See *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 503–504; see also cases cited at p. 24 of our initial brief.

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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, PETITIONER

vs.

W. H. WARDLAW, INDEPENDENT EXECUTOR OF THE ESTATE OF C. W. WARDLAW, DECEASED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR REHEARING

Now comes the petitioner, W. H. Wardlaw, Independent Executor of the Estate of C. W. Wardlaw, Deceased, by his counsel, and respectfully prays for a rehearing of this case.

This petition is brought because the Opinion of the Court contains an erroneous statement of material fact, vital to the decision rendered. At page 3, the Opinion states that "Each of the respondents *elected*" to use the "unit-livestock-price" method of valuing his inventories;[1] where-

[1]At page 3, the Opinion states: "Each of the respondents elected the 'unit-livestock-price' variant of the accrual method of accounting for his overall ranching operation.5" Footnote 5 of the Opinion cites Treas. Reg.1.471-6 as the authority for this method; the method was **first prescribed** for livestock raisers by the 1944 predecessor of Reg.1.471-6, namely, Reg.111, Sec.29.22(c)-6.

as the uncontroverted fact is that the respondents in the *Wardlaw* case, as distinguished from the respondents in the *Catto* case,[2] did *not* so elect, but were *compelled* to use that method when it was first prescribed by the Commissioner's Regulations in 1944.

The decision of the Court apparently turns on the respondents having made an election under Reg. 1.471-6(f), the Opinion tracing the history, describing the operation, and expressly upholding the validity, of Reg. 1.471-6(f), which provides that a "taxpayer who *elects* to use the unit-livestock-price method" of valuing his inventories "must apply it to all livestock raised", including his breeding animals, thereby treating his breeding animals as inventory items even though they are, by statutory definition, "property used in the trade or business." The Opinion concludes that Reg. 1.471-6(f) is "neither arbitrary nor inconsistent with the revenue statute or with other regulations under the statute." The Court's position appears to be that having *elected* the *advantages* of the method of inventory valuation prescribed by Reg. 1.471-6(f) the taxpayers are bound by their election and must assume whatever *burdens* the election may entail.

In discussing the doctrine of election, Merten's, *The Law of Federal Income Taxation*, Section 60.19, p. 74, states that *"The doctrine of election implies that a taxpayer is given the option of freely taking two courses of action; where there is no freedom of choice and the election is by compulsion, the rule is inapplicable."* Cited authority includes *Thompson-King-Tate, Inc. v. U.S.*, 296 F.2d 290 (CCA 6th, 1961), and *Ross v. Commissioner*, 169 F.2d 483 (CCA 1st, 1948). To similar effect, see definition of election in

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[2] **United States v. John Catto, Jr. and Roxana Catto**, 344 F.2d 227, and **United States v. W. H. Wardlaw, Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.**, 344 F.2d 225, are the two separate and distinct Court of Appeals cases covered by the Opinion of this Court in **United States, Petitioner, v. John Catto, Jr. et al.** The Government saw fit to join these two cases for purposes of seeking review by this Court.

Maguire & Zimet, *Hobson's Choice and Similar Practices in Federal Taxation*, 48 Harv.L. Rev. 1281, at p.1285.

It is no doubt true that the taxpayers in the *Catto* case *did* elect to use the unit-livestock-price method, for the obvious reason that they began business after the method was first prescribed by the Regulations in 1944 and therefore were in a position to select or reject the method; it is equally true, however, that the taxpayers in the *Wardlaw* case *did not* elect to use the unit-livestock-price method, for the reason that they began business *before* the method was first prescribed by the Regulations in 1944, and in 1944 *they were not offered any election at all*, but, on the contrary, were *compelled to use* the unit-livestock-price method because of an express provision of the Regulations adopted in 1944, which read as follows:

> "A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis *will be considered as having elected* the 'unit-livestock-price method'." T.D. 5423, 1945 Cum.Bull. 70.

Obviously, the taxpayers in the *Wardlaw* case cannot be bound by an election they did not make. As stated in Merten's, supra, "where there is no freedom of choice and the election is by compulsion, the rule is inapplicable."

It would thus appear that, possibly as a consequence of two dissimilar cases having been joined for purposes of review, the Court has inadvertently decided the *Wardlaw* case on the basis of the facts in the *Catto* case, overlooking the critical difference that *the taxpayers in the Catto case had a true election under Reg.1.471-6(f), whereas the taxpayers in the Wardlaw case had no election at all.*

Under these circumstances, it would seem that justice requires further consideration of the *Wardlaw* case by this Court.

CONCLUSION

By reason of the foregoing, the petition for rehearing should be granted.

Respectfully submitted:

CLAIBORNE B. GREGORY

ELWOOD CLUCK

Attorneys for W. H. Wardlaw, et al, Respondents

CERTIFICATE OF COUNSEL

I hereby certify that the foregoing petition for rehearing is presented in good faith and not for purposes of delay.

CLAIBORNE B. GREGORY

SUPREME COURT OF THE UNITED STATES

No. 535.—October Term, 1965.

United States, Petitioner, v. John Catto, Jr. et al.	On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit.

[April 26, 1966.]

Mr. Justice Stewart delivered the opinion of the Court.

The question presented in this case is whether taxpayers engaged in the livestock business who use an accrual method of accounting for animals raised for sale may employ a cash method of accounting for animals raised for breeding purposes, in order to take advantage of a federal income tax benefit available to cash-method taxpayers when breeding animals are sold.

The respondents are ranchers engaged in the business of raising livestock for sale. As an important element of their business, the respondents maintain herds of livestock used for breeding purposes. During the taxable years in question, the respondents sold animals from their breeding herds and reported the gains from the sales in accord with the accrual method of accounting they had elected for their overall ranching operations. Subsequently, they filed claims with the Commissioner of Internal Revenue for partial tax refunds, on the ground that they were entitled to use the more advantageous cash method of accounting in calculating the gain from sales of their breeding livestock. The Commissioner rejected the claims, and the respondents brought suit to obtain the refunds. Their claims were sustained by the

District Court,[1] and the judgments were affirmed by the Court of Appeals for the Fifth Circuit.[2] We granted certiorari to resolve a conflict among the Circuits.[3] We now reverse the judgments of the Court of Appeals.

Section 1231 of the Internal Revenue Code of 1954, 26 U. S. C. § 1231, provides that in certain circumstances gains from the sale of property used by a taxpayer in his trade or business may be treated for federal income tax purposes as long-term capital gains. Section 1231(b)(3) makes the section specifically applicable to sales of livestock held for breeding purposes.[4] No challenge is raised

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[1] *Wardlaw* v. *United States,* 223 F. Supp. 631 (D. C. W. D. Tex.); *Catto* v. *United States,* 223 F. Supp. 663 (D. C. W. D. Tex.).

[2] *United States* v. *Wardlaw,* 344 F. 2d 225; *United States* v. *Catto,* 344 F. 2d 227.

[3] The Court of Appeals affirmed the judgments of the District Court on the authority of its prior decision in *Scofield* v. *Lewis,* 251 F. 2d 128. But see *Carter* v. *Commissioner,* 257 F. 2d 595, 600–601 (C. A. 5th Cir.). The Eighth and Ninth Circuits have taken a contrary position and have refused to permit taxpayers using an accrual method of accounting for their overall ranching operation to employ a cash method of accounting for breeding livestock. *United States* v. *Ekberg,* 291 F. 2d 913 (C. A. 8th Cir.); *Little* v. *Commissioner,* 294 F. 2d 661 (C. A. 9th Cir.).

[4] Section 1231 of the Internal Revenue Code of 1954, 26 U. S. C. § 1231, provides in relevant part:

"§ 1231. *Property used in the trade or business and involuntary conversions.*

"(a) *General rule.*

If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from

here to the classification of the animals sold by the respondents as livestock held for breeding purposes within the meaning of that provision. Our sole concern is with the measure of the respondents' capital gain.

Each of the respondents elected the "unit-livestock-price" variant of the accrual method of accounting for his overall ranching operation.[5] Under that method, the

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sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. . . .

"(b) *Definition of property used in the trade or business.*

For purposes of this section—

. . . . . .

"(3) *Livestock.*

Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry."

[5] The unit-livestock-price method is described in Treas. Reg. § 1.471–6, which provides in relevant part:

"§ 1.471–6. *Inventories of livestock raisers and other farmers.*

. . . . . .

"(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products . . . farmers raising livestock may value their inventories of animals according to . . . the 'unit-livestock-price method.'

. . . . . .

"(e) The 'unit-livestock-price method' provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and

respondents classified their livestock inventory by age and kind and assigned a standard unit price to the animals in each class. Both breeding animals and animals raised for sale were lumped together in the respondents' inventories, and the same unit prices were employed for both types of livestock. By multiplying the number of animals in each class by the unit price for the class, the opening and closing inventory valuations were readily calculated for each taxable year.

The applicable Treasury Regulations grant a current deduction for the expenses incurred in raising livestock, without regard either for the purpose for which the animals are raised or for the method of accounting employed by the taxpayer.[6] For ranchers who have elected the cash method of accounting, the current deduction is of course taken against ordinary income in the year the expense is paid. Since, as a result, the adjusted basis of the breeding animals at the time of sale is zero, the entire proceeds of the sales are reported as capital gains.

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unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. . . .

"(f) A taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner."

The values suggested in Reg. § 1.471–6 (e) have remained unchanged since they were first introduced into the Regulations in 1944. T. D. 5423, 1945 Cum. Bull. 70. Appropriate classifications and unit prices currently recognized by the Internal Revenue Service are: Calves, $40; yearlings, $55; 2-year olds, $70; mature animals, $85. See Farmer's Tax Guide, Internal Revenue Service Publication No. 225, p. 33 (1966 ed.).

[6] Reg. § 1.162–12: ". . . The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay . . . ."

Because of the mechanics of the accrual method of accounting used by the respondents, however, their current deductions for the expenses of raising their livestock were offset by the annual increments in the unit inventory values of the animals not sold during the taxable year.[7] The adjusted basis of the animals sold was therefore equal to the accumulated increments in their unit values, and only the proceeds of sale in excess of that basis were reported by the respondents as capital gain.[8] Although the respondents' capital gain was lower than the gain they would have reported had they used the cash method of accounting, the reduction was achieved at the cost of annulling the current deduction from ordinary income of the expenses of raising their breeding livestock. As a result, the respondents' overall tax on their gains from the sale of breeding livestock was larger than it would have been had they used the cash method of accounting with respect to those animals.[9] The Court of

[7] Under Reg. § 1.61–4 (b), the gross income of accrual method ranchers is measured by the sum of sales income during the taxable year and closing inventory, less the sum of expenses incurred in raising the animals during the year and opening inventory. See also Reg. § 1.162–12. The mechanics of that computation accomplish the bookkeeping operation of subtracting the cost-of-goods-sold from sales income. The effect of the use by the respondents of their inventory method of accounting is simultaneously to add to ordinary income the annual increments in the unit values of their unsold breeding livestock and to subtract the annual costs of raising the animals.

[8] Under the theory of the unit-livestock-price method, the accumulated increments in the unit values of the livestock should equal the total expenses incurred in raising the animals. In effect, therefore, the expenses incurred by the respondents in raising their breeding livestock were deferred until the year of sale.

[9] In other words, under both the cash and accrual methods of accounting, the expenses incurred in raising breeding livestock are currently deductible, and the proceeds of sale in excess of those expenses are taxed as capital gains. The essence of the difference between the two accounting methods in the circumstances of this case lies in the tax treatment of the portion of the sales proceeds

Appeals held in the present case that the respondents were not required to use the accrual method of accounting for their breeding livestock, and that they were therefore entitled to report the gains from the sales of those animals in accordance with the more advantageous cash method.[10] We think the Court of Appeals was in error.

The respondents' principal contention is that breeding livestock are simply not the type of asset that is prop-

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that represents the recovery of the expenses incurred in raising the animals. That portion of the proceeds is taxed to cash-method ranchers at rates applicable to capital gains, whereas it is taxed to accrual-method ranchers at rates applicable to ordinary income. Thus, with respect to sales of breeding livestock, the cash method of accounting offers ranchers a route by which ordinary income can be transmuted into capital gain. See Mertens, Law of Federal Income Taxation § 22.130, p. 569; Jamison, Tax Planning with Livestock and Farming Operations, 1961 So. Calif. Tax Inst. 583, 599–607.

To the extent, of course, that the expenses actually incurred in raising their breeding livestock exceed the estimated unit valuations, accrual-method ranchers are themselves able to transmute ordinary income into capital gain. It is therefore to the advantage of accrual-method ranchers to place low unit valuations on their breeding livestock.

[10] The respondents proposed to accomplish their shift in accounting procedure in two steps: First, by deducting from ordinary income the adjusted basis of the breeding livestock actually sold during the taxable years and to treat the entire proceeds of the sales as capital gain in the year of sale; Second, by eliminating from their inventories all remaining livestock held for breeding purposes and achieving a zero basis for those animals by deducting from ordinary income their existing unit valuations, which represent the accumulated costs of raising the animals. Even though the Court of Appeals sustained the claims of the respondents, the court noted that the correction would result in an inordinate deduction against ordinary income in the year the adjustment was made, since expenses properly allocable to prior years would be bunched in the year of the correction. 344 F. 2d 227, 229. In the District Court, some of the respondents had suggested that, in the alternative, the inventory correction for breeding livestock not yet sold might be accomplished by allowing reduction of the accrued unit values to a zero basis over a five-year period.

erly includible in inventory. Just as manufacturers do not put capital equipment in inventory, so, respondents claim, they need not place their breeding livestock in inventory. Therefore, they say, the method of deferral of expenses worked for inventory-type assets by the mechanics of accrual accounting under Treas. Reg. § 1.61–4 (b)[11] is completely inapplicable to such livestock, because the animals should never have been placed in inventory in the first place. The result of freeing breeding livestock from the accounting procedure of Reg. § 1.61–4 (b) would be to enable the respondents to obtain the benefits of the cash method, since the current deduction under Reg. § 1.162–12 would no longer be offset by the annual increments in the unit values of their breeding livestock.

Although the contention of the respondents is not without force, we believe that the evolution of the statute and regulations here in question demonstrates that the expenses of raising breeding livestock were intended to be deferred by accrual-method taxpayers. That interpretation of the legislative and administrative history is fully consonant with accounting logic, and we therefore conclude that the Commissioner should prevail.

The general and long-standing rule for all taxpayers, whether they use the cash or accrual method of accounting, is that costs incurred in the acquisition, production, or development of capital assets, inventory, and other property used in the trade or business may not be currently deducted, but must be deferred until the year of sale, when the accumulated costs may be set off against the proceeds of the sale.[12] Under general principles of

[11] See notes 7 and 8, *supra*.

[12] Internal Revenue Code of 1954, §§ 263, 471, 1011–1013, 1016 (a)(1); Reg. §§ 1.263 (a)–2 (a), 1.471–1, 1.1016–2. Cf. I. T. 1309, I–1 Cum. Bull. 196 (1922). See *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 183–187; *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 185; *Snyder* v. *Commissioner*, 295 U. S. 134, 141, n. 4. Cf. Moen,

accounting, therefore, it would be expected that expenses incurred by ranchers in raising breeding livestock should be charged to capital account, even though the ranchers employed the cash method of accounting.

As early as 1919, however, in response to the specific need for a relatively more simplified method of farm accounting than was available even under the cash method as it then existed, the Secretary of the Treasury and the Commissioner of Internal Revenue promulgated Regulations expanding the cash method to authorize a current deduction for expenses incurred by farmers and ranchers in raising crops and animals.[13] Although the question does not appear to have arisen, it is hardly likely that the Commissioner would have permitted accrual-method ranchers, for whom the new procedure was not designed, selectively to apply the simplified cash method to their breeding livestock or any other part of their herds. At the time these Regulations were issued, and for more than two decades thereafter, gains from the

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Special Capital Gains Treatment for Farmers, 17 Ohio St. L. J. 32–41 (1956). Thus, a cash-method rancher who purchases an animal for breeding purposes must capitalize the cost of the purchase. I. T. 3666, 1944 Cum. Bull. 270; Reg. § 1.162–12.

[13] Regulations 45, Art. 110 (April 17, 1919 ed.) (Revenue Act of 1918) provided in part: ". . . The cost of feeding and raising live stock may be treated as an expense deduction . . . ." See Reg. § 1.162–12, note 6, *supra*. Cf. Regulations No. 33 (Revised), ¶¶ 30, 404–405 (Revenue Act of 1916, as amended by Revenue Act of 1917). At the time the Regulations under the Revenue Act of 1918 were promulgated, it appears that the Bureau of Internal Revenue did not recognize specialized techniques of accrual accounting for approximating and deferring the costs of raising an animal to maturity. See Special Letter from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, June 27, 1952, 98 Cong Rec., Pt. 6, p. 8307, 1952 CCH Fed. Tax Rep. ¶ 6239. At least by 1922, however, the accrual method of accounting had been explicitly adapted to the complexity of farm operations. Regulation 62, Arts. 38, 1586 (2) (1922 ed.) (Revenue Act of 1921). See also note 21, *infra*.

sale of breeding livestock were taxed as ordinary income.[14] Thus, the choice of accounting method affected only the timing of the deduction for the expenses of raising the animals, and no serious distortion of taxable income was introduced when ranchers elected the cash method for their breeding livestock.[15] Throughout this period, no distinction appears to have been drawn between breeding and other livestock in the inventories maintained by ranchers using the more sophisticated accrual method of accounting. Indeed, since 1922, the Treasury Regulations have specifically contemplated that all livestock, whether raised for breeding or other purposes, were to be included in the inventory of accrual-method ranchers.[16]

In 1942, however, Congress added § 117 (j) to the Internal Revenue Code of 1939.[17] That section, the

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[14] Favorable tax treatment for capital gains was born into the income tax law in the Revenue Act of 1921, but gains from the sale of breeding livestock continued to be treated as ordinary income. Cf. Wells, Legislative History of Treatment of Capital Gains under the Federal Income Tax, 1913–1948, 2 Nat. Tax. J. 12 (1949).

[15] The principal utility of the simplified cash method was that it enabled farmers and ranchers to escape the complexity of establishing and deferring the precise costs of raising their breeding animals. Compare Reg. § 1.471–6 (c), *supra*, note 5. In addition, ranchers using the cash method possessed substantial flexibility in determining the year in which income was realized. The defects of the method were that it produced a bunching of income in the year of sale and an inaccurate matching of income from the sale of the livestock with the expenses incurred in raising the animals. The accrual method, on the other hand, involved neither bunching of income nor inaccurate matching of income with expenses. Moreover, under the unit-livestock-price variant of the accrual method of accounting chosen by the respondents, the incremental amounts taken into inventory each year as the livestock increased in value were available as a source of income against which the expenses incurred in raising the animals could be deducted.

[16] Regulations 62, Art. 1586 (1) (1922 ed.) (Revenue Act of 1921).

[17] Revenue Act of 1942, c. 619, 56 Stat. 798, 846, § 151 (b).

progenitor of § 1231 of the 1954 Code, established capital gain treatment for the sale of "property used in the trade or business" of the taxpayer. The general language of the 1942 amendment left the tax status of breeding livestock in doubt, and the ensuing nine years found the Commissioner and ranchers jockeying for position on the treatment of gains from the sale of such animals.[18] Congress resolved the controversy in 1951 by amending § 117 (j) to make clear that capital gain treatment was to be accorded to gains from the sale of livestock raised for breeding purposes.[19] Predictably, the amendment encouraged attempts by accrual-method ranchers to transfer to the cash method of accounting. The Commissioner, however, refused to permit the changes where

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[18] See I. T. 3666, 1944 Cum. Bull. 270; I. T. 3712, 1945 Cum. Bull. 176; Special Ruling by Commissioner of Internal Revenue, Aug. 4, 1947 (1948 CCH Fed. Tax Rep. ¶ 6091) (capital gain treatment available to cash-method ranchers only for extraordinary sales of breeding livestock, such as in reduction of herd size, not for animals culled from the breeding herd in the normal course of business because of age or disease); *Albright* v. *United States*, 173 F. 2d 339 (C. A. 8th Cir.) (capital gain treatment available to cash-basis ranchers, even for routine sales of breeding livestock); *Fawn Lake Ranch Co.* v. *Commissioner*, 12 T. C. 1139, appeal dismissed, 180 F. 2d 749 (C. A. 8th Cir.) (capital gain treatment available to accrual-method ranchers for sales of breeding livestock, even though the animals had been included in inventory); *United States* v. *Bennett*, 186 F. 2d 407 (C. A. 5th Cir.) (breeding livestock not held primarily for sale); Mim. 6660, 1951–2 Cum. Bull. 60 (capital gain treatment not available for breeding livestock unless animals used as breeders for substantially their full breeding lives).

[19] Revenue Act of 1951, c. 521, 65 Stat. 452, 501, § 324. The amendment, which was carried forward without change as § 1231 (b)(3) of the 1954 Code, extended from six to 12 months the holding period required before sale of the livestock could qualify as a capital gain. A lingering effort by the Commissioner to impose certain additional criteria concerning age and reproductive capacity and use of breeding livestock was rejected by the Court of Appeals for the Second Circuit. *McDonald* v. *Commissioner*, 214 F. 2d 341.

it appeared that the sole motivation for the shift was to reap the capital gain windfall available to cash-method ranchers.[20]

The issue raised by the respondents ultimately centers on the validity of Reg. § 1.471–6 (f), which requires that a "taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised, whether for sale or for . . . breeding . . . purposes." That provision is neither arbitrary nor inconsistent with the revenue statute or with other regulations under the statute. The unit-livestock-price method is soundly grounded in accepted principles of accounting. It has been specifically recognized by the tax laws as a valid approach to livestock accounting for more than 20 years.[21] Moreover, as the practice of the respondents indicates, the expenses incurred in the production and development of their livestock were essentially the same, whether the animals were raised for sale or for breeding purposes, and the unit-livestock-price method of accounting provided convenient and efficient annual estimates of those expenses. There can thus be no question that the

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[20] Because we hold here that the Commissioner could validly refuse to acquiesce in the respondents' proposed change in their accounting method, we have no occasion to consider the effect either of the respondents' failure to request his permission or of their attempt to initiate the change after their returns for the taxable years had been filed. See Reg. § 1.471–6 (a). Compare Bureau of Internal Revenue Release, 1953 CCH Fed. Tax Rep. ¶ 6191 (May 12, 1953), announcing that the Bureau at that time would no longer withhold action on requests by livestock raisers to change their methods of accounting.

[21] The unit-livestock-price method was not formally recognized in the Treasury Regulations until 1944. T. D. 5423, 1945 Cum. Bull. 70, amending Regulations 111, § 29.22 (c)–6 under the 1939 Code. It appears, however, that comparable methods of estimating livestock values had long been informally available to ranchers. See Mim. 5790, 1945 Cum. Bull. 72.

respondents' accounting method accurately reflected their income.

Were we concerned, therefore, solely with the applicability to breeding livestock of the unit-livestock-price method of accounting, we would be unable to characterize as arbitrary the Commissioner's refusal to permit the change the respondents seek. Congress has granted the Commissioner broad discretion in shepherding the accounting methods used by taxpayers,[22] and the uniform application of the unit-livestock-price method to the respondents' entire livestock operation is a reasonable exercise of the discretion rested by Congress in the Secretary and the Commissioner for the administration of the tax laws. "It is not the province of the court to weigh and determine the relative merits of systems of accounting." *Brown* v. *Helvering,* 291 U. S. 193, 204–205; *Lucas* v. *American Code Co.,* 280 U. S. 445, 449; *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180, 189–190; *Commissioner* v. *Hansen,* 360 U. S. 446, 467; *Schlude* v. *Commissioner,* 372 U. S. 128, 133–135.

The issue in the present case, however, is complicated by the substantial tax differential worked by the Treas-

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[22] Internal Revenue Code of 1954, §§ 7805; 446 (a)–(c), (e); 471; Reg. §§ 1.446–1 (e)(2), 1.471–6 (f). Reg. § 1.471–6 (f) requires only that ranchers who use the unit-livestock-price method for livestock raised for sale must also apply the method to livestock raised for breeding purposes. By that procedure, a unitary accounting system is established for all livestock raised by the ranchers. The Commissioner does not contend that livestock raised for breeding purposes and livestock raised for sale must be maintained in the same inventory, and no question is raised here concerning the availability to ranchers of a depreciation deduction on the unit value of livestock that have been raised to maturity for breeding purposes. Cf. Reg. §§ 1.61–4 (b), 1.167 (a)–6 (b). Compare I. T. 3712, 1945 Cum. Bull. 176; Mim. 5790, 1945 Cum. Bull. 72. Also, no question is raised here concerning the status of livestock that a rancher has purchased, rather than raised, for breeding purposes. See Reg. § 1.471–6 (g).

ury Regulations in favor of cash-method ranchers and against accrual-method ranchers when breeding livestock are sold. It is the position of the Commissioner that the Treasury Department is unable by administrative action to require cash-method ranchers to capitalize the expenses incurred in raising their breeding livestock.[23] The respondents contend that so long as the present dichotomy is maintained, they are entitled to participate in the benefits available under the cash method.

We need not determine whether in all cases the Commissioner may legitimately refuse to acquiesce in the transition by ranchers from the accrual method to the cash method of accounting. The Commissioner is not, of course, obliged to permit taxpayers to shift their accounting methods to accommodate every fluctuation in the revenue laws. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90, 97; *Commissioner* v. *South Texas Lumber Co.*, 333 U. S. 496. We may assume *arguendo* that particular legislative or administrative mutations in the tax laws

[23] The Secretary has stated that the Treasury Department is foreclosed by the legislative history of the 1951 amendment from eliminating by Regulation the capital gain windfall available to cash-method ranchers. Special Letter from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, *supra*, note 13. Both of the Committee Reports on the Revenue Act of 1951 stated that "gains from sales of livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and *presently* recognized by the Bureau of Internal Revenue." S. Rep. No. 781, 82d Cong., 1st Sess., p. 42, 1951–2 Cum. Bull. 458, 488; H. R. Rep. No. 586, 82d Cong., 1st Sess., p. 32, 1951–2 Cum. Bull. 357, 380. (Emphasis added.). We need not here determine the correctness of the Secretary's interpretation of the legislative history, since no question is presented in this case concerning the vulnerability of the position of cash-method ranchers to action by the Secretary. Similarly, because of the grounds on which we rest our decision, we do not pass upon the Commissioner's contention that the legislative history established a mandate by Congress in favor of his position in the present case.

may foster inequities so great between taxpayers similarly situated that the Commissioner could not legitimately reject a proposed change in accounting method unless the taxpayer had exercised a meaningful choice at the time he selected his contemporary method. No such substantial inequity is presented here. The respondents have not sought to embrace the cash method of accounting for their entire ranching operation. To the contrary, they ask that they be permitted to subject only their breeding livestock to that method. Thus, they propose to retain the advantages of the accrual method for their livestock raised for sale.

It is clear that application of the cash method of accounting to sales of breeding livestock would substantially distort the economic picture of the respondents' ranching operations.[24] The sacrifice in accounting accuracy under the cash method represents an historical concession by the Secretary and the Commissioner to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure. A concomitant of the special dispensation that has been made available to cash-method ranchers is the favorable capital gain treatment that results whenever breeding livestock are sold. The respondents, however, have demonstrated their intent to retain the accuracies of the unit-livestock-price method of accounting for animals they have raised for sale. That method was itself introduced as a special concession to accrual-method ranchers, who were thereby enabled to avoid the difficulties of establishing the actual costs of raising their livestock. The respondents' desire to shift from the unit-livestock-price accrual method to the cash method for their breeding livestock is therefore divorced from the sole rationale for which each of those account-

[24] See note 15, *supra*.

ing methods was made available. By selectively combining attributes of both methods, the respondents seek to fashion a hybrid system that would defeat the Commissioner's goal of providing a unitary accounting method for all taxpayers. It clearly lay within the discretion of the Commissioner to reject such a hybrid system of accounting, and the Court of Appeals was in error in accepting the respondents' claims. See *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357, 360; *Commissioner* v. *South Texas Lumber Co.*, 333 U. S. 496, 503–504; *Commissioner* v. *Hansen*, 360 U. S. 446, 467; *Little* v. *Commissioner*, 294 F. 2d 661, 664 (C. A. 9th Cir.); *Carter* v. *Commissioner*, 257 F. 2d 595, 600 (C. A. 5th Cir.); *Elsie SoRelle* v. *Commissioner*, 22 T. C. 459, 468–469.

The judgments are therefore reversed and the case is remanded to the Court of Appeals for the Fifth Circuit for further proceedings consistent with this opinion.

It is so ordered.